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TWENTY YEARS OF INTERNATIONAL STUDIES: AN EXPOSITION OF STUDENT WRITING

Comment from the Editor

This issue celebrates a twenty year tradition: the *Denver Journal of International Law and Policy*. The *Journal* today stands as a vibrant and essential component of the International Legal Studies Program at the University of Denver College of Law. The McDougal lecture, given annually by an eminent legal scholar to our student body, is published here, as are papers presented in the annual Symposium. The Sutton Award Paper, selected from submissions by University of Denver law students, is also an annual feature of the *Journal*. Working on the *Journal* allows our students to become familiar with well known and respected scholars and with the tradition of the law, and enter into debates on emerging norms and new issues. And just as important: the *Journal* serves as a stage for the debut of new voices.

In this past year, the *Journal* has completely updated every aspect of its operation, from new computer and Lexis equipment to more mundane matters such as new letterhead and computerized bookkeeping. We are proud of these changes, and hope they will enable us to better serve our audience. However, computers and fancy bookkeeping are merely cosmetics; the lifeblood of the *Journal* is the hardwork and energy supplied by our student staff and the support given by the College of Law.

This issue is a sampling of the scholarship of our student body, showcasing the broad range of interests and experiences that make the study of international law at D.U. so stimulating. Our featured student writers include a lawyer licensed in both Germany and now the United States, a former U.S. Senate aide, and a C.P.A..

The only non-student piece in this issue is the Capital Markets article. This section appears regularly in the *Journal*, and has proved very popular with our subscribers. The Capital Markets Section is a cooperative effort involving *Journal* staff and local practitioners, another example of the strong support we enjoy from the larger legal community. Beginning in Volume 21, we will expand our coverage of economic issues with a new International Trade Section, which will explore topics such as the interaction between trade and environmental protection, labor issues, and the new regional common markets being birthed worldwide. The *Journal* will also continue to maintain its leadership position publishing articles on human rights and environmental issues.

International law typically changes at a glacial pace. However, events of the last several years have forced rapid reassessment of the conventional wisdom. It is an exciting time for all lawyers, but especially for those of us just entering the practice. The *Journal* is and will continue to be a forum where changes and new issues can be discussed. We hope you enjoy the voices debutting here today.

Debra Asimus

East-West Joint Ventures: Lessons From Past Soviet-Western Joint Ventures and Projections for Future Deals With the CIS

I. INTRODUCTION

In the past five to six years, former President Mikhail Gorbachev and a new group of young thinkers have revolutionized the philosophy and practice of foreign relations in the Soviet Union.[1] They have rejected the traditional idea of autarchy, or economic nationalism, and replaced it with an understanding that they should become part of the world financial and trading system.[2]

The Joint Venture Decree of 1987 opened the Soviet Union to Western business for the first time in seventy years.[3] Western business entrepreneurs have eagerly embraced the idea of accessing both resources and markets formerly forbidden to them. However, the practical realities of developing and conducting business in a society with no basic law of contracts, no knowledge of market economics, and no understanding of work performance tied to rewards has proved daunting.

Joint venture successes, when they have occurred, have involved extensive negotiations between Western partners and their Soviet business counterparts plus approvals by principals in the Soviet central ministries, the republic governments and, sometimes, local administrations. However, as the republics emerge as sovereign states and central Soviet control disappears, questions emerge about how best to pursue business with the new Commonwealth of Independent States.

This essay will review the changes in Soviet law that have led to current hospitable business relationships. Next, it will discuss the recent Soviet societal changes that make continuing steps to establish a joint venture questionable. Finally, the essay will attempt to marshal insights from the Soviet experience and project the most likely scenarios for future East-West business.

II. ISOLATIONIST HISTORY

The introduction of Communism during the Russian Revolution of 1917 effectively ended all foreign investment that had been allowed under

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1. Richard N. Gardner, *The Triple Crisis of the Soviet Union Today*, 11 N.Y.L. SCH. J. INT'L & COMP. L. 435, 437 (1990).
2. *Id.*
3. Nicole M. Houri, *Joint Venture Law in the Soviet Union*, 11 N.Y.L. SCH. J. INT'L & COMP. L. 499, 504 (1990).

the czarist regime.[4] The small beginnings of open trade had ended; the West was shut out. In March of 1921, Lenin sought to revitalize the Soviet economy with his New Economic Policy (NEP) by partially restoring Western business interests. Lenin's 1923 "Law on Concessions" allowed more foreign participation in Soviet businesses.[5] This open market policy was short lived, however, and in 1930 Josef Stalin outlawed joint ventures with all foreign firms, stating that it was ideologically improper for any part of the Soviet Union to be under foreign control.[6]

Thus, from the late 1920s until the end of 1986, the Soviet Union exercised absolute state control over foreign trade.[7] Two characteristics typified this state monopoly: first, private persons were barred from engaging in business transactions with non-socialist partners or from holding currencies that had value elsewhere; and second, state firms engaged in production were prohibited from dealing directly with capitalist businesses.[8] Foreign trade organizations (FTO's), subordinate to the Ministry of Foreign Trade, acted as intermediaries and handled all contracts with foreigners for items available only from the West.[9]

The FTO's might have been viable had they been able to work directly with the foreign firms that they served. Instead, national plans issued by "Gosplan," the State Planning Commission, directed the FTO's negotiations with the West.[10] State central planning restrictions also gave the FTO's a special operational agenda that minimized hard currency expenditures, which normally led to buying the cheapest goods, and that maximized hard currency return on Soviet produced goods, while compensating Soviet firms only in rubles. This currency return policy decreased the incentive for Soviet firms to produce quality goods for export.[11] In addition, the FTO's acted as information barriers. Since Soviet firms had little contact with foreign customers or suppliers, they had no way to learn about new technology that could enhance their production or about changes in overseas demand.[12]

III. THE WINDS OF CHANGE

By the early 1980s, central planning and isolationism had placed the Soviet economy in decline, triggering the need to re-evaluate Soviet restrictions on foreign investment. In 1983, the Soviets approved joint ven-

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4. *Id.* at 500.
5. *Id.*
6. *Id.*
7. Paul B. Stephan III, *The Restructuring of Soviet Commercial Law and Its Impact on International Business Transactions*, 24 GEO. WASH. J. INT'L L. & ECON. 89, 90 (1990).
8. *Id.*
9. *Id.*
10. John P. Feldman, *Soviet Joint Ventures: Providing for Appropriate Dispute Resolution*, 23 CORNELL INT'L L.J. 107, 111 (1990).
11. Stephan, *supra* note 7.
12. *Id.* at 91.

tures with other socialist countries, and by 1986 they had officially started to discuss partnerships involving Western investors.[13] The Soviet Joint Venture Decree of January 1987 opened the first avenue for direct investment in the USSR in over sixty years.[14]

The government believed that the traditional centrally planned economy had not provided a level of development equivalent with industrialized capitalist nations.[15] For this reason the government introduced *perestroika*, the policy to allow controlled entry of Western investment and technology. Joint ventures were seen as the crucial vehicle for stimulating newly permitted private cooperatives which provided an important source of Western management skills and technology.[16] From a Western view point, joint ventures remain attractive because they offer access to what is potentially the world's largest untapped market for Western goods and services.[17] The Soviet Union also represents a store of abundant natural resources.[18] General benefits may accrue to the Western world, including decreased defense spending and greater social and cultural interactions with Soviet citizens.[19]

The disadvantages of conducting business with the Soviet Union continue: a shortage of materials, unreliability of transportation systems,[20] and the non-convertability of the ruble.[21] While it is positive that Western companies can now directly deal with their relevant Soviet counterparts, Soviet domestic enterprises simply have very little or no understanding of business practices in the West and still less experience with negotiating and implementing foreign trade contracts.[22]

IV. FUNDAMENTALS OF SOVIET JOINT VENTURES

A proposed joint venture with the Soviet Union should meet "Joint Venture Decree" objectives, as well as the criteria from subsequent proclamations, to gain approval.[23] The Decree states that joint ventures should be approved for several purposes: to satisfy domestic requirements for certain types of industrial products, raw materials and food stuffs; to

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13. Houri, *supra* note 3, at 501.

14. Decree of the USSR Council of Ministers on the Establishment in the Territory of the USSR and Operation of Joint Ventures with the Participation of Soviet Organizations and Firms from Capitalist and Developing Countries, No. 49 (Jan. 13, 1987) [hereinafter Joint Venture Decree]; *see also* Daniel J. Arbess, *A Few Things U.S. Businesspeople Should Know About Joint Ventures in the Soviet Union: A Lawyer's View*, 22 INT'L L. & POL. 411 (1990).

15. Houri, *supra* note 3, at 502.

16. Arbess, *supra* note 14.

17. *Id.* at 412.

18. Houri, *supra* note 3, at 502.

19. *Id.* at 503.

20. Stephan, *supra* note 7, at 92.

21. Arbess, *supra* note 14, at 412.

22. *Id.* at 414.

23. Joint Venture Decree, *supra* note 14, at art. 1.

attract advanced foreign technologies, management expertise, additional material and financial resources to the USSR national economy; to expand exports; and to reduce superfluous imports.[24] The Decree also lists other areas for expansion: research and design, engineering, sales and marketing, finance, and service industries such as tourism.[25]

The three phases of development involved in creating joint ventures are discussion, contract negotiations, and official registration.[26] Successful discussions with a legally recognized prospective Soviet partner and the relevant government officials will lead to the signing of a protocol letter or letter of intent.[27] Though not binding, this letter captures each venturer's understanding of its respective responsibilities and the general goals of the joint venture.[28]

A feasibility study will then follow to more fully examine the venture's possible difficulties and to clarify each partner's role.[29] This study includes a cost analysis, projected earnings, and technical assumptions.[30] Finally, the necessary joint venture documents are prepared, including the joint venture agreement, the joint venture statute and all ancillary contracts, and submitted for approval to the USSR Ministry of Finance for registration, and to the administrative organ that exercises control over the Soviet partner.[31]

The joint venture is also required to specify the objectives of its operation.[32] The concept of "ultra vires" is treated very seriously by Soviet authorities, and there is evidence that joint ventures with overly broad objectives may not be approved.[33] More importantly, Western companies must recognize that the Soviets place great emphasis on the written word.[34] They negotiate contract terms carefully and will rely on a contract as an accurate and exclusive reflection of the matters contained therein. Their position tends to be that what is not explicitly permitted by the written terms of any agreement or contract is not permitted at all.[35]

Soviet tax law, labor law and property law are all binding on the joint venture partners, unless they are exempt under international treaties to

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24. *Id.* at art. 1 § 3.
25. Decisions of the CPSU Central Committee and the USSR Council of Ministers on Additional Measures to Improve the Country's External Economic Activity in the New Conditions of Economic Managment, No. 1074 (Sept. 17, 1987).
26. Houri, *supra* note 3, at 503.
27. *Id.*
28. Feldman, *supra* note 10, at 115.
29. Houri, *supra* note 3, at 503-504.
30. Feldman, *supra* note 10, at 115.
31. Houri, *supra* note 3.
32. Joint Venture Decree, *supra* note 14, at art. 7.
33. *Id.* at art. 51.
34. *Arbess*, *supra* note 14, at 414.
35. *Id.*

which the USSR is party.[36] In addition, Article 1 of the Joint Venture Decree should be of particular concern to the Western partner, since it allows the Soviets to control joint ventures by enacting "other legislative acts of the USSR and Union Republics."[37]

All the above considerations have required Western partners to anticipate and address many potential contractual issues to maximize the success of the venture. Broad economic reforms, republic and central government laws, as well as the evolving structure of joint venture arrangements have had to be constantly monitored so that the negative impacts of any political or legal change could be minimized.

A. *Status of Joint Ventures in the Soviet Union*

As of January 1, 1990 there were 1,274 registered Soviet joint ventures with foreign partners.[38] However, only 184 of them had successfully maneuvered their way through the system and begun operations.[39] Matters of implementation have been complicated by the fact that Western companies cannot necessarily depend on their Soviet partners to guide them through the changing political and legal terrain.

B. *Legal and Operational Concerns*

The Soviet legal system is immature. Unlike a country possessing an established legal framework and body of precedent, the parties to a joint venture in the Soviet Union have had to negotiate and document many seemingly "standard" legal and business issues.[40] There is no Soviet equivalent of the Delaware Corporation Code — partners must establish a basic corporate framework for governance.[41]

The basic legal and business concerns of contribution valuation, profit repatriation, property rights, financing, taxes, and dispute resolution, plus special operational concerns about workers and supplies, have all had to be addressed. Any one area has the potential of derailing a business deal. The following sections outline how each of these business concerns has been dealt with in the past.

1. Contribution Valuation

Western partners need to determine early in the process how much to invest in a venture, and what share of equity capital this investment will represent. Soviet joint venture law permits many types of capital con-

36. Houri, *supra* note 3, at 505.
37. *Id.*
38. FINANCIAL TIMES, Jan. 31, 1990, at 14.
39. *Id.*
40. Jeffery A. Burt, *Joint Venture Experience: Observations on the Business and Legal Challenges*, 22 INT'L L. & POL. 435, 445 (1990).
41. *Id.*

tributions.[42] Because the ruble is not a convertible currency, the Western partner is most likely to contribute hard currency and technology, while the Soviets will tend to provide mineral and property rights.[43] The 1987 Decree allows the parties to determine their respective equity shares by negotiation and to appraise their contributions in either rubles or hard currency.[44] Such negotiations ultimately focus on valuation: determining the value of the goods and services each partner proposes to contribute in exchange for their equity.[45]

Unfortunately, how to value each partner's contributions is one of the most difficult portions of the joint venture process. The Joint Venture Decree says contributions shall be valued by referring to world market prices, but it offers little direction on how to attach value to assets for which there is no market in the Soviet Union.[46] "Specifically, the value of Soviet real estate and natural resources will be difficult to assess because Soviets have consistently appraised them below market value by Western standards."[47] Likewise, there is no common standard by which the Western partner's "know-how" can be valuated.[48]

As a starting point, evidence of prior sales and valuations (particularly sales in the East Bloc), sales by comparable companies, current production costs, the value of licensing similar technology, and the cost of producing equivalent technology in the USSR can be submitted by the Western partner for examination.[49] The best approach so far appears to be to value the Soviet contribution in rubles and the Western contribution in hard currency.[50] This gives the Western partner a hedge against the risk of capital dissolution related to planned devaluations of the ruble.[51] By using this technique, a devaluation of the ruble would simply decrease the relative value of the Soviet partner's share resulting in a redistribution of equity ownership.[52] The mechanism for carrying out such a redistribution should be spelled out in a clause in the joint venture agreement specifically requiring the parties to revalue the ruble value of capital contributions.

2. Profit Repatriation

The ruble's non-convertability is a major obstacle to Western companies contemplating joint ventures in the USSR.[53] While both of the part-

42. Houri, *supra* note 3, at 509.
43. *Id.*
44. *Id.*
45. Arbess, *supra* note 14, at 416.
46. Joint Venture Decree, *supra* note 14, at art. 12.
47. Houri, *supra* note 3, at 509.
48. *Id.*
49. *Id.*
50. Arbess, *supra* note 14, at 419.
51. *Id.* at 418.
52. *Id.* at 419.
53. *Id.* at 430.

ners want the venture to earn money, the Western investor is mainly interested in repatriating profits while the Soviet investor's need is to increase the government's hard currency supply by keeping profits in the country.[54] Foreign partners have a guaranteed right under the Joint Venture Decree to transfer their share of profits abroad.[55] However, this right is worthless unless the joint venture has foreign currency available for this purpose. The average Soviet family does not have hard currency to spend so Western joint venture partners cannot expect to receive the type of money that they can repatriate from sales to the Soviet domestic market.[56]

To partially overcome this barrier to profit repatriation, the Soviets allowed the American Trade Consortium, a grouping of U.S. companies, to pool their respective joint venture generated foreign exchange cash flows.[57] This allows the consortium members who have joint ventures focused toward export markets to exchange excess amounts of hard currency at negotiated rates with other consortium members who sell products to the Soviet market for rubles. Another option that the Soviets have considered is using a special ruble backed by their gold reserves that would be convertible into Western currencies.[58]

Counter-trade deals have been the more usual way for joint ventures to earn hard currency. These deals allow Western goods to be exchanged for Soviet goods that are later sold for hard currency to the West.[59] Approximately half of all Eastern European contracts currently have some counter-trade provisions. In fact, it is estimated that one quarter of all world trade is actually counter-trade.[60] Combustion Engineering, for example, became the first U.S. partner in a Soviet joint venture,[61] using a counter-trade arrangement where it sells computer software and processing equipment to Soviet refineries and receives Soviet-produced petrochemicals as payment, which it then sells to other Western companies for hard currency.[62] Pepsico has counter-traded bottling factories and syrup for vodka.[63] Pepsico also agreed to train Soviet workers and to assist with bottling plant engineering, design, and construction. Twenty-six bottling plants now exist in the Soviet Union.[64]

One obstacle to counter-trade is the scarcity of Soviet commodities that meet quality standards necessary to make goods exportable to West-

54. Houri, *supra* note 3, at 509-510.
55. Joint Venture Decree, *supra* note 14, at art. 32.
56. Houri, *supra* note 3, at 510.
57. N.Y. TIMES, Mar. 31, 1989, at D4.
58. Houri, *supra* note 3, at 511.
59. *Id.* at 510.
60. Leo Welt, *Unconventional Forms of Financing: Buy-Back/ Compensation/Barter*, 22 INT'L L. & POL. 461, 467 (1990).
61. Burt, *supra* note 40, at 438.
62. Houri, *supra* note 3, at 511.
63. Burt, *supra* note 40, at 439.
64. Welt, *supra* note 60, at 466.

ern markets.[65] If the commoditites do meet Western market standards, the Soviet manufacturer may decide to market the products abroad itself, thereby avoiding the role of the joint venture "middleman."[66]

3. Property Rights

Property rights, based on the presumption that each party to a transaction understands what it receives for what it gives, are the foundation for commercial transactions in the West.[67] Western joint venture laws have historically given the joint venture itself all property rights, or allowed the individual parties to retain ownership of their separate contributions.[68]

The Soviet partner's main contribution to a joint venture typically is the right to use land areas and other resources.[69] However, a Soviet partner does not "own" the land that is contributed, since all land in the Soviet Union is "within the exclusive ownership of the State."[70] All natural resources, land and water are leasable to joint ventures under terms decided upon by the Council of Ministers.[71] Procedural rules and the type of resources involved guide decisions by the Council on what fees to charge for the right to use lands or resources.[72]

Before the 1990 amendment to the Soviet Constitution, private ownership of the means of production was historically forbidden by both Marxist-Leninist ideology and the Soviet Constitution.[73] The Supreme Soviet began reworking its private property laws beginning in 1988 with the Law on Cooperatives.[74] Cooperatives became the first private firms to legally hire employees and amass capital.[75]

More liberal measures were added in the winter of 1989 and 1990 with the enactment of the Fundamentals of Leasing Legislation, which established a legal basis for transferring possession and use of state property to private firms. The Fundamentals of Land Legislation, the Law on Property and associated constitutional amendments followed, and subsequently reworked the definition of property rights in the Soviet Union.[76] Currently, legislation recognizes state, collective and citizens' property,

65. Houri, *supra* note 3, at 511.
66. *Id.*
67. Stephan, *supra* note 7, at 93.
68. Houri, *supra* note 3, at 508.
69. Arbess, *supra* note 14, at 417.
70. KONST. SSSR (1977), art. 11, *reprinted in* F. J.M. FELDBRUGGE, THE CONSITUTION OF THE USSR AND THE UNION REPUBLICS: ANALYSIS, TEXTS, REPORTS 111 (1979).
71. Procedure Assessing the Land, Natural Resources, Buildings and Structures Forming Part of the Soviet Parties' Contribution to the Authorized Capital of Joint Ventures for Temporary Use § 1.1 (Feb. 9, 1988).
72. *Id.* at § 2.1.
73. Stephan, *supra* note 7, at 93.
74. *Id.*
75. *Id.*
76. *Id.*

with the latter two categories including private productive assets.[77] Private ownership of land is still forbidden.

Individuals can invest only in firms with which they maintain some labor relationship. Property and non-property personal rights can be acquired by a joint venture in its own name.[78] Joint ventures are protected, under Article 17 of the 1987 decree, in a manner quite similar to Soviet state organizations, including protection allowances for copyrights and patents.[79] Ownership of technology is not covered by Soviet law.[80]

A startling development was the October 26, 1990 Presidential Decree which authorized direct investment by foreigners in the Soviet economy.[81] The decree may well place foreigners on an equal basis with Soviet citizens in terms of rights recently created and protected by property legislation.[82]

4. Financing

Article 27 of the Joint Venture Decree allows joint ventures to use both rubles and convertible currencies to raise debt capital.[83] *Vnesheconombank* (the USSR Bank for Foreign Trade) has made initial financing directly available to joint ventures in foreign currency from non-Soviet sources.[84]

The dominant issue for a Western bank is how a loan is collateralized. Increasingly, the borrowers involved will be self-financing, privately-owned businesses formed in the image of Soviet cooperatives or other forms of associations.[85] In the past, banks have been willing to finance joint ventures when the Western partner backs the venture with guarantees, or when the partners pledge equity interests in the joint venture.[86] However, joint venture partners will continue to prefer to pledge joint venture assets.[87]

As as result, Western banks are considering increased "limited recourse" financing based on traditional project finance credit evaluation criteria. An example is the recent cooperation between Moscow Narodny Bank (a Soviet-owned U.K. bank based in London), and the Finnish Postipankki Bank that provided $10.7 million in financing for a joint venture hotel renovation in Tallinn, Estonia.[88] The Finnish partners have par-

77. *Id.* at 94.
78. Joint Venture Decree, *supra* note 14, at art. 6.
79. Houri, *supra* note 3, at 508.
80. *Id.*
81. Stephan, *supra* note 7, at 91.
82. *Id.*
83. Joint Venture Decree, *supra* note 14, at art. 27.
84. *Id.*
85. *Id.*
86. *Id.*
87. *Id.*
88. *MNB in USSR Joint Ventures*, TRADE FINANCE, Apr. 1989, at 5.

tially guaranteed the loan, but a major portion of the loan is secured by a collateral assignment of a construction contract, as well as by the partners' promise to ensure sufficient occupancy rates and to guarantee high management standards.[89]

5. Taxes

In the recent three and one half year period when joint ventures have been allowed, nine separate legislative or regulatory acts related to joint venture taxation have been issued by five separate governmental groups.[90] In January of 1987, the Council of Ministers first allowed establishment of joint ventures, provided that they would be taxed at thirty percent of their profits, with an exemption from payment for the first two years of operation.[91] A September 1987 joint decree from the USSR Central Committee and the Council of Ministers modified the original tax holiday so that it would run from the time when declared profits were first received.[92] This is an important benefit for Western partners because a joint venture might not produce profits for up to ten years.[93] Payment of the thirty percent profits tax can be indefinitely delayed if the joint venture's earnings are used for expansion, or to increase its various reserve and development funds.[94]

In December 1988, a Decree was adopted by the Council of Ministers extending the tax holiday for joint ventures in the Far Eastern economic region to three years after profits are first declared.[95] In 1989, the USSR's Supreme Soviet Presidium gave the Council of Ministers more flexibility in granting reductions and exemptions from taxation to joint ventures.[96] The most recent enactment was the June 1990 "Law on the Taxes on Enterprises, Associations and Organizations," which limited tax concessions to joint ventures in two ways: first, profits are to be taxed at thirty percent only if the foreign partner's investment in the capital fund exceeds thirty percent, otherwise the tax rate is the same as for other Soviet enterprises (maybe as high as forty-five percent); second, service and other non-production oriented joint ventures, plus fishing or mineral extraction joint ventures are no longer eligible for the tax holiday.[97]

In addition to the profits tax, a twenty percent withholding tax is

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89. *Id.*

90. Michael Newcity, *Tax Issues in Soviet Joint Ventures*, 25 TEX. INT'L L.J. 163, 168 (1990).

91. *Id.* at 169.

92. *Id.* at 170.

93. Houri, *supra* note 3, at 513.

94. Joint Venture Decree, *supra* note 14, at art. 30.

95. Decree of the USSR Council of Ministers on the Further Development of Foreign Economic Activities of State, Cooperative, and other Public Enterprises, Entities, and Organizations, No. 1405, arts. 28, 31 (Dec. 2, 1988).

96. Newcity, *supra* note 90, at 171.

97. *Id.* at 172.

also levied on all profits repatriated by Western partners.[98] However, since the USSR has entered into double taxation agreements including provisions relating to the taxation of royalty, interest and dividend income with most of its Western trading partners, it is likely that the joint venture will be relieved from paying part, or all of this withholding tax if the transaction is structured so that a portion of the profits are characterized as royalty payments, interest or dividends.[99]

Finally, foreign employees of a joint venture must pay income tax in the USSR if they are located there for more than 183 days during a calendar year.[100] New legislation, in effect as of July 1, 1990, imposes a sixty percent tax rate on monthly incomes in excess of 3,000 rubles.[101] Since many of the non-Soviet employees of a Western-Soviet joint venture will earn more than this amount, which is equivalent to a $60,000 annual income, the resulting tax liability imposed on foreign employees is substantial.[102]

Change has been the predominant characteristic of Soviet tax policy toward joint ventures since the 1987 Joint Venture Decree.[103] It is fair to say the current laws are only temporary. Another area of considerable potential change lies with the republics and local authorities. Several of them are drafting their own tax laws and all are likely to play a much greater role in future taxation of joint ventures.[104]

6. Dispute Resolution

Article 20 of the 1987 Joint Venture Decree provides that disputes shall be settled "according to legislation of the USSR either by the USSR courts or, by common consent of both sides, by an arbitration tribunal."[105] The term "courts" in the Soviet context actually refers to their economic regulation and enforcement system called *arbitrazh*.[106] *Arbitrazh* is an administrative agency that implements and then monitors national economic plans through union and republic level branches.[107] It functions much like a court of law in that it hears cases after there has been a private resolution attempt.[108] Whether *arbitrazh* should ever be used for dispute resolution for joint ventures is questionable given its administrative nature and its adherence to the Soviet economic plan.[109]

98. Joint Venture Decree, *supra* note 14, at art. 41.
99. Newcity, *supra* note 90, at 189 n.133.
100. *Id.* at 202.
101. *Id.* at 203.
102. *Id.*
103. *Id.* at 206.
104. *Id.* at 207.
105. Feldman, *supra* note 10, at 116.
106. *Id.*
107. *Id.*
108. *Id.* at 117.
109. *Id.* at 118.

U.S. federal courts could be used for a Soviet-U.S. joint venture dispute if the hurdle of potential sovereign immunity under the Federal Foreign Sovereign Immunity Act could be overcome.[110] However, it is not clear whether federal or state law would be applied, and, if the Soviet partner does not have assets in the U.S., the U.S. partner cannot enforce the judgment.[111] The application of foreign law is not unknown, however. For example, Swedish courts were utilized in 1988 when the American Trade Consortium persuaded its Soviet partner to arbitrate disputes.[112]

Arbitration may be the best way to adapt an agreement to unforeseen changes.[113] The joint venture agreement should contain a section covering arbitration in three parts. First, a general clause covering all disputes is necessary, and should specify the language to be used as well as acceptance of the UNCITRAL rules, which permit the selection of an institution capable of assisting with the administration and organization of the dispute resolution. The drafting of the arbitration clause should be supervised by the Stockholm Chamber of Commerce, a recognized international arbitration institution. Second, a clause distinguishing technical disputes to be arbitrated by "on site" experts and reviewable by the tribunal is necessary in the general arbitration clause. Finally, it is important to include a clause recognizing areas where increased contact with the state would be beneficial to the enterprise and where certain actions would warrant submission to *arbitrazh*.[114]

7. Labor

Supervising and motivating a local work force that has traditionally not been rewarded for productivity is a difficulty that has always affected foreign investments in Eastern Bloc countries.[115] In fact, the preamble to the USSR Constitution contains the Soviet ideology of eliminating capitalist exploitation of the people.[116]

Soviet labor law is "voluminous and complex," consisting of labor codes and uncodified statutes promulgated by both federal and republic lawmakers.[117] In addition, there are countless regulatory decrees designed to implement statutes. The decrees are so numerous and detailed that they are often more important than the underlying statutes.[118] Local norms also play an important role in labor concerns. Finally, USSR and

110. *Id.*
111. *Id.* at 119.
112. Houri, *supra* note 3, at 505.
113. Feldman, *supra* note 10, at 119.
114. *Id.* at 129.
115. Houri, *supra* note 3, at 514.
116. F.J.M. Feldbrugge, *The Constitution of the USSR*, 16 REV. SOCIALIST L. 163, 167 (1990) (citing the USSR CONSTITUTION, preamble).
117. Kevin P. Block, *The Disciplining and Dismissal of Employees by Joint Ventures in the USSR*, 23 GEO. WASH. J. INT'L L. & ECON. 619, 621 (1990).
118. *Id.* at 622.

republic courts periodically issue "guiding explanations" to lower courts.[119]

On the whole, there are four notable characteristics of Soviet labor law. First, there is an extraordinarily powerful role assigned to trade unions; second, the central government regulates many issues that are left to bargaining in Western cultures; third, the system is very protective of workers; and fourth, there is a quick and inexpensive, if not always equitable, means to resolve employee disputes.[120] Two fundamental concepts underlie all of Soviet labor law: "all Soviet citizens have a right to a job and all able-bodied citizens have a corresponding duty to work."[121]

Under the 1987 Decree, over half of a joint venture's employees had to be Soviets, which required that joint ventures abide by the very stringent requirements of Soviet labor law.[122] From the perspective of the Western partner, the December 1988 Decree appeared to simplify employment matters by permitting questions of hiring and dismissal, the form and scale of labor pay, and material incentives to be determined in negotiations between the parties.[123] Read literally, this language would return the USSR to the employment-at-will doctrine.[124]

The validity of this provision is highly questionable, however, since it violates Soviet labor laws, the Soviet Constitution,[125] and is in opposition to powerful ideological, historical and political precedents.[126] A concrete example concerns dismissals. Soviet labor law requires an exclusive list of grounds for termination and prior union consent for most dismissals.[127] Courts will not only reverse a dismissal that was put into effect without union consent, but will charge the responsible managers with personal fines.[128]

The May 1989 Decree now says that decisions by a joint venture on these matters must be consistent with all the USSR "legislative acts" that govern the rights of its citizens.[129] But "legislative acts" is a general phrase. It is not clear whether "legislative acts" are intended to include general norms applicable to Soviet citizens, or only the specific legislative acts applicable to state enterprise employees.[130]

Without being able to offer meaningful material incentives to encourage increased quality and production, Soviet enterprises have re-

119. *Id.*
120. *Id.* at 622-632.
121. *Id.* at 623.
122. Houri, *supra* note 3, at 514.
123. Arbess, *supra* note 14, at 424.
124. Block, *supra* note 117, at 626.
125. Houri, *supra* note 3, at 515.
126. Block, *supra* note 117, at 626.
127. *Id.* at 625.
128. *Id.*
129. Arbess, *supra* note 14, at 424.
130. *Id.*

sorted to a complex system of punishment for those who do not follow the rules.[131] Articles 127 through 138 of the RSFSR Labor Code cover discipline and speak in very general terms of employee obligations while imposing a long list of duties on management.[132] Only a few people are allowed to impose discipline, and failure to follow the proper steps (including requesting a written explanation of the event from the employee, receiving permission from the trade union to administer discipline, issuing a directive enunciating the basis for the discipline and giving it to the employee no later than three days after its issuance for the employee's signature) may render the disciplinary measures void.[133]

The grounds for actual dismissal of an employee are limited by Articles 33 and 254 of the labor code.[134] Among those most likely to be imposed by a joint venture are:

a. *Violation of Labor Discipline*. A frequently litigated action, which allows an employer to terminate an employment contract for "inadequate work performance, insubordination, or other numerous forms of unsatisfactory behavior."[135]

b. *Abenteeism*. Many of these cases arise in connection with transfers. Since employees must consent to a transfer to another job, employees who feel they have been improperly transferred sometimes do not report to their new positions.[136] Dismissals in these cases will stand only if the transfer was legal.

c. *Layoffs*. The labor code recognizes this as a permissible ground for dismissal, but it has been largely unused in the USSR.[137] Certain employees are classified as having preferential rights to remain at work, but performance results are not listed as a criteria for that right.[138] Two months notice must be provided and, if possible, the employee must be provided with alternative work.[139]

d. *Flagrant Breach of Duty*. Nothing in the statute indicates what actions or inactions constitute a flagrant breach, and it is unclear whether a court or the joint venture's board of directors would review such a dismissal since a joint venture isn't under a ministry's jurisdiction.[140]

e. *Loss of Confidence*. Intentional wrongdoing is not required,

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131. Block, *supra* note 117, at 627.
132. *Id.* at 628.
133. *Id.* at 631-632.
134. *Id.* at 639.
135. *Id.* at 640.
136. *Id.* at 641-642.
137. *Id.*
138. *Id.* at 643.
139. *Id.* at 644.
140. *Id.* at 645.

just an improper act indicating extreme carelessness.[141] There must be individualized proof of wrongdoing.[142]

f. *Miscellaneous.* This includes inability to work for more than four months unless it is due to a job related accident; a person who previously held the job reclaims the position; the employee is not qualified; the employee is committed by a court to a drug or alcohol rehabilitation program; and immoral acts committed by people in the educational system.[143]

Trade unions also have the authority to dismiss management employees under Soviet law.[144] Potential targets of a trade union demand for dismissal include all individuals in the management staff.[145] With this authority, unions instituted more than 6,000 administrative actions in 1979 against management officials, which resulted in 146 dismissals. By 1985, the number of actions had almost doubled.[146]

8. Procurement and Product Quality

Product quality in the USSR is strongly dependant on access to supplies.[147] Unlike state enterprises, joint ventures are not guaranteed access to sources of natural resources and production materials, nor are they guaranteed a market for their resulting products and services.[148] A November 1988 amendment to the 1987 Joint Venture decree allowed joint ventures to use either hard currency or rubles to purchase supplies directly from Soviet producers.[149] But purchasing supplies has been troublesome since joint ventures have no priority and manufacturers few goods left after filling state plan orders.[150]

Importation of equipment, materials and other property is an alternative supply source.[151] Only convertible currency, however, can be used to make payments.[152] Soviet customs has also remained unclear about how it will treat components that are sent regularly from overseas as contributions that are not part of equity.[153]

Chronic supply shortages and no industry competition have resulted in inferior product quality and low Soviet consumer expectations. Yet quality must be high to meet Western standards, or the Western partner

141. *Id.*
142. *Id.* at 646.
143. *Id.* at 647.
144. *Id.* at 649.
145. *Id.* at 650.
146. *Id.* at 649-650.
147. Houri, *supra* note 3, at 516.
148. Arbess, *supra* note 14, at 428.
149. Houri, *supra* note 3, at 516.
150. *Id.*
151. Arbess, *supra* note 14, at 429.
152. Houri, *supra* note 3, at 516.
153. Arbess, *supra* note 14, at 429.

will not want to lend its trade name.[154] The McDonald's joint venture required over twelve years to negotiate, partly because McDonald's quality standards could only be met by establishing a large farm outside Moscow to grow potatoes and other food products.[155] But very few Western companies can afford to invest as heavily as McDonald's, which brought in its own supply chain and production equipment for the staggering sum of $50 million.[156]

V. THE NEW PLAYING FIELD

Joint ventures may not have thrived in the environment described above, but they had made headway in the new liberalized world of *perestroika*. Before the disintegration of the USSR, the Soviet central government was beginning to have some market-based business experience to rely on, and further market expansion was planned.

However, changes catalyzed by the "controlled" release of information, *glasnost*, were not complete. After seventy years of threatening the whole world, the Soviet Union split apart in six short years. What happened? In changing the nature of power relations the Soviet Union had to change its ideology, which had guaranteed "an absence of serious national conflicts, a quiescent working class and the solidarity of the ruling elite."[157] Gorbachev chose to implement the change by limiting the Communist party and exposing its vices. However, control of the relevant information was quickly lost, resulting in discredit to the legitimacy of Soviet rule as a whole.[158]

Wall Street Journal headlines on Monday, December 23, 1991, officially announced the end: "Eleven Republics Lay USSR to Rest."[159] On December 11, 1991, Russia, Byelorussia and the Ukraine created the Commonwealth of Independent States (CIS). They accepted the popular demands for independence by the republics, framed a confederation, and intended to allow non-communist private enterprise and private markets to flourish.[160] Eight of the remaining nine Republics, Azerbaijan, Armenia, Kazakhstan, Kirgizia, Moldavia, Tajikistan, Turkmenia and Uzbekistan, signed on as co-founders on December 21 and 22, 1991.[161] Georgia joined the CIS early in 1992 following the resolution of its internal fighting over republic leadership.[162]

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154. Houri, *supra* note 3, at 515.
155. Burt, *supra* note 40, at 439.
156. Houri, *supra* note 3, at 515.
157. David Satter, *The Seeds of Soviet Instability*, WALL ST. J., Sept. 20, 1991, at A10.
158. *Id.*
159. Elisabeth Rubinfien, *Eleven Republics Lay U.S.S.R. to Rest*, WALL ST. J., Dec. 23, 1991, at A6.
160. *Goodby USSR, Hello CIS*, WALL ST. J., Dec. 13, 1991, at A14.
161. Rubinfien, *supra* note 159.
162. *Slavic Shakeout*, WALL ST. J., Feb. 14, 1992, at A12.

The republics had reacted to the new information filtering out of the Kremlin with a surge of nationalism.[163] The people were informed that the Baltics did not join the Soviet Union voluntarily, but were part of a secret Molotov-Ribbentrop Pact between Hitler and Stalin; that the placement of Nagorno-Karabakh in the territory of Azerbaijan was part of a strategy of divide and rule; and that the Ukrainian famine of 1932-33 which claimed the lives of millions was artificially induced.[164]

The breakup of the world's last great empire is actually an enormous process of decolonization.[165] The Soviet empire was not the Russian empire; the Russians were colonized just as much as the people in the Ukraine, Georgia and Kazakhstan.[166]

When the fictional world of Soviet ideology was removed, the republics rediscovered their own history and recovered in spirit, if not in name, separate statehood.[167] The August coup attempt, with its threat to plunge the republics back into the repressive conditions of old, catalyzed the Russian spirit and moved an outraged citizenry into the streets in defense of their new-found freedoms. Afterward, it may well have been Gorbachev's continued insistence on maintaining a powerful central government which finally solidified the resolve of the republics' leaders to reject the Soviet system.[168]

What does this mean for existing Western-Soviet joint ventures? Do we start again? Will all the rules be new? How should a new joint venture begin? The answers to all these questions lie in following the lead of the republics. The foundation for the Commonwealth is state independence.[169] The only agreements reached in the early days of the CIS were that pricing policies would be coordinated, the ruble would remain the common currency (though sources differed on whether the Ukraine intended to issue its own), each republic would pursue its own economic policy, each republic would have equal status in the CIS, central military leadership would transition to military groups in each republic, and Russia would occupy the Soviet Union's General Assembly and Security Council seats in the United Nations.[170]

In truth, the world has twelve new nations to learn about, plus the three Baltic Republics already granted independence earlier in 1991. If the revolution had been pre-planned, the various republics would have negotiated a pact long ago with provisions for an association of free na-

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163. Satter, *supra* note 157.

164. *Id.*

165. Jack F. Matlock Jr., *The Politics of Russian Economic Reform*, WALL ST. J., Nov. 5, 1991, at A6.

166. *Id.*

167. Satter, *supra* note 157, at A10.

168. Peter Gumbel, *As Soviet Events Seem to Bypass Gorbachev, Talk is of His Legacy*, WALL ST. J., Dec. 13, 1991, at A1.

169. Rubinfein, *supra* note 159 (quoting Boris Yeltsin).

170. *Id.*

tions with a common currency, a common economic space and centralized control over weapons of mass destruction.[171] Lacking such forethought, what is clear now is that the nations that made up the Soviet Union must move apart before they can find their way back to a limited union.[172] From a Western perspective, our first step is to learn as much as possible about our new business partners (See Appendix).

A. *The Republics: Tension between Interdependence and Separation*

From the start, the union was actually a confederation formed from national or multinational entities that were often artificially defined.[173] When it was formed in 1922, the Soviet Union consisted of Russia, two republics (the Ukraine and Belorussia), two confederations (the Peoples Republics of Central Asia and Turkestan), plus an ersatz confederation of Georgia, Armenia and Azerbaijan.[174] The reorganization of Central Asia resulted in five republics roughly divided along ethnic lines, and which were officially added to the Soviet Union in the 1920s and 1930s: Uzbekistan (1925), Turkmenistan (1925), Tadzhikistan (1929), Kazakhstan (1936), and Kirgizia (1936).[175] Next, Bessarabia was annexed from Romania to form Moldavia and finally, in 1940, the Baltics (Latvia, Lithuania and Estonia) were incorporated as a result of the now notorious Hitler-Stalin agreement.[176]

Today, the 286 million people who live in the CIS and the Baltic states are from the same geographic regions where their ancestors have lived for centuries;[177] but in creating its new world order, the Socialists tried to level any cultural differences by depriving people of their homelands through deportation, radical changes in living conditions, and forced changes in ethnic composition via in-migration and resettlement.[178] Much of the discontent in the republics today is directly tied to the depletion of natural resources, and the cultural and environmental degradation of cities and farms by central planning authorities.[179]

1. Interdependence

The republics must first face the realization that most of them cannot exist on their own.[180] The majority of Soviet products are made from

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171. Matlock Jr., *supra* note 165, at col. 4.
172. *Id.*
173. Thomas J. Samuelian, *Cultural Ecology and Gorbachev's Restructured Union*, 32 HARV. INT'L L.J. 159, 168, (1991).
174. *Id.*
175. *Id.* at 169.
176. *Id.*
177. *Id.* at 164.
178. *Id.*
179. *Id.*
180. Paul Hofheinz, *Let's Do Business*, FORTUNE, Sept. 23, 1991, at 64.

raw materials or parts from more than one republic.[181] The central planners gave the republics bits and pieces of industry and agriculture, but ensured that no republic was self sufficient in goods or services.[182] A few notable facts include:

> a. Russia produces ninety per cent of the oil and most of the natural gas output of the Soviet Union,[183] but still must import grain from the Ukraine and the West, cotton from the Central Asian Republics, and meat and dairy products from the Baltics.[184]
>
> b. The Baltics depend on other republics for two-thirds of their goods and services.[185]
>
> c. Armenia has the only factory that makes a filter used in all power stations. Without it, there is no electricity and lights go out everywhere.[186]
>
> d. Uzbekistan was largely self-sufficient in food until central planning decided in the 1950s that the Soviet Union needed more cotton. So, five million farmers there were forced to switch. Now, Uzbekistan produces seventy per cent of the Soviet Union's cotton while it imports food.[187]
>
> e. Mongolia lacks a dependable telephone system, facsimile machines are almost unknown and its people, primarily from rural areas, are ignorant about a market driven system.[188]
>
> f. Moldavia and Georgia are in critical need of enormous investments in infrastructure — from road construction to phone systems.[189]

An economy like this is particularly susceptible to disruption if interrepublic trade breaks down. The pursuit of independence and separate currencies risks just such a breakdown.[190] Only Russia, the Ukraine, and possibly Uzbekistan may have the resources and hard currency earning potential to survive a collapse in intra-republic trade,[191] but even that is doubtful considering their commitment to service their share of the old

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181. Craig Forman, *Soviet Economy Holds Potential Disaster As the Union Weakens*, WALL ST. J., Sept. 4, 1991, at A1.
182. *Id.* at A6.
183. Elisabeth Rubinfien, *Yeltsin Seizes Control of Soviet Resources*, WALL ST. J., Nov. 18, 1991, at A13.
184. Forman, *supra* note 181, at A6.
185. *Id.*
186. *Id.*
187. *Id.*
188. Susan Carey, *Free From Moscow, Mongolia Makes Up for Lost Time by Embracing Markets*, WALL ST. J., Oct. 3, 1991, at A14.
189. Hofheinz, *supra* note 180, at 65.
190. *Saving Soviet Trade*, FIN. TIMES, Nov. 21, 1991, at 22.
191. *Id.*.

Union's foreign debt.[192] A leading Soviet scientist, Yevgeny Velikhov, warned that failure to preserve at least some current economic links would "turn the Soviet Union into little more than a Third World producer of raw materials."[193]

There is no indication of what will happen to the long-term agreement that allows U.S. grain exports to go to the Soviet Union.[194] The central government agency *Exportkhleb* bought for all republics; some are now considering importing on their own, others can't afford individual importing.[195] Conditions for a successful new federation include rapid agreements on a monetary system, a customs union so that republics won't set up tariff barriers against each other, and an agreement on uniform commercial and civil laws.[196]

2. Separation Activity

"The hypernationalism dominating life in many republics interferes with rational economic decision-making," says Andrei Kortunov, a political analyst at the Soviet Academy of Sciences.[197] Squabbles over natural resources and economic assets pit the republics against each other.[198] Escalation can be expected when they confront, for example, who controls genuinely Soviet assets such as Aeroflot, the national airline, and who will pay what portion of the Soviet Union's existing sixty four billion hard currency debt.[199]

"Its working by seizure," says Abraham Becker, director of the Rand Corporation's UCLA Center for Soviet Studies in California. "If it's in my back yard, it's mine."[200] Examples include the Baltic Republics and Russia who are claiming control over federal assets in their territory.[201] Azerbaijan, Uzbekistan and Kazakhstan say oil located on their land belongs to them.[202]

The republics also have different foreign policy interests. For example, Tadjikistan is a predominantly Muslim republic that sees itself tied to Europe, but has interests that are different from Russia.[203] Most republics want consular, cultural and economic affairs to be directed by

192. *Id.*
193. Forman, *supra* note 181.
194. *Id.* at A6.
195. *Id.*
196. *Id.*
197. Gerald F. Seib, *U.S. Loses Hope that Coherent Economy Will Link Nationalistic Soviet Republics*, WALL ST. J., Oct. 28, 1991, at A10.
198. Forman, *supra* note 181.
199. *Id.*
200. *Id.* at A6.
201. *Id.*
202. *Id.*
203. Peter Gumbel, *Russia's Foreign Minister Seeks to Unite Republics on Key Issues*, WALL ST. J., Nov. 8, 1991, at A12.

their own people.[204]

The need to exhibit true independence is also evidenced by the following:

> a. Russian President Boris Yeltsin freed price controls for many products on January 2, 1992.[205] He also reduced foreign aid and credits to all countries, began charging market prices for Russia's natural resources, sold or gave away government-owned housing and unprofitable state farms, and ended the uncontrolled printing of currency.[206] In April of 1992, state controlled energy prices were also freed.[207] The Russian economic-reform team has maintained a strict credit policy since the first of the year to stabilize the economy.
>
> b. Russia is also taking control of Soviet gold reserves, diamonds, precious metals, and oil exports, which are the main collateral for the nation in its efforts to secure more international credit.[208] Russia produces sixty seven per cent of Soviet gold and has claimed control of the entire resource, notwithstanding the theory that republics in a new union should mutually work out a plan to divide debt obligations and resources.[209]
>
> c. The Ukraine plans to introduce its own currency and has banned exports of scarce consumer goods to other republics.[210] However, soaring prices in Russia have forced the issuance of a temporary coupon currency.[211] A capital fund has been created for the republic's new National Bank of Ukraine and special multiple-use coupons are now used in Ukrainian stores to prevent the out-flow of goods to other republics.[212]
>
> d. Both Russia and Ukraine have laid claim to the 300-ship Black Sea fleet which sales out of Sevastopol, a Ukrainian port.[213]
>
> e. Mongolia plans to privatize most state enterprises and cooperatives, sell land to private investors, wipe out debts of companies to be sold, provide credit to new small businesses, and train brokers, bankers, and managers in the ways of the market.[214]

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204. *Id.*

205. Adi Ignatius, *Backlash to Russian Price Rises Stops Short of Violence So Far*, WALL ST. J., Jan. 20, 1992, at A6.

206. *Yeltsin Goal: Free Market*, DENV. POST, Oct. 29, 1991, at A2.

207. Laurie Hays, *Russia Yielding on its Policy of Tight Money*, WALL ST. J., Mar. 20, 1992, at A6.

208. Rubinfien, *supra* note 183.

209. *Id.*

210. Forman, *supra* note 181.

211. Tim Carrington, *Ukraine Falters Over Creating Currency*, WALL ST. J., Jan. 31, 1992, at A10.

212. Natalia Feduschak, *Ukraine Keeps a Firm Stance as Moscow Raises Pressure on Republic to Cooperate*, WALL ST. J., Oct. 23, 1991, at A12.

213. Adi Ignatius, *Black Sea Fleet Stranded in Tug-of-War*, WALL ST. J., Jan. 17, 1992, at A8.

214. Carey, *supra* note 188.

f. Georgia is allowing foreign companies to bid for mineral water concessions.[215]

g. Kazakhstan and Azerbaijan are negotiating with foreign petroleum firms, including Chevron and Amoco, for oil exploration rights.[216] Elf Aquitaine, a French owned oil giant, signed a pact with Kazakhstan in February of 1992 to allow oil exploration and production sharing.[217]

h. Almost half of Afganistan's total revenue is made from natural gas sales.[218] It is offering to sell its huge reserves to European markets for cash to rebuild its economy.[219]

3. Economic, Ethnic and Leadership Difficulties

As if the independence/separation tug-of-war wasn't enough, economic, ethnic and leadership problems are ripping at the core of the CIS's existence. The country is lurching through a draconian depression: GNP fell by ten per cent in the first half of 1991, while the budget deficit ballooned to over thirty three and one half billion dollars.[220] Since prices were liberalized in January of 1992, the Russian inflation rate has rocketed upward by 300%, while production has dropped by half in some sectors.[221] Yeltsin's program did not allow for industry privatizations along with price increases, so factories remain state owned and no real competition has begun.[222] Instead, true to their bureaucratic training, factories jointly have raised all their prices to a higher fixed level to insure their mutual survival.[223] Central planning has simply been replaced by self-imposed industry controls at a high cost to the common people.

Winter hit the republics in midstride between the old system and the new.[224] The cost of staple foods in Russia bounced up tenfold and many people survived on reserves of food that they had stockpiled before the price increases.[225] Enough food and fuel exist for everyone in the republics, but the transportation system simply cannot deliver all the goods.[226] More than a quarter of available grain is wasted, and over half the pota-

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215. Hofheinz, *supra* note 180, at 65.
216. *Id.*
217. Robert Johnson, *Kazakhstan, Elf Aquitaine Set Oil Pact*, WALL ST. J., Feb. 19, 1992, at A8.
218. *Afghanistan Offers Natural Gas*, WALL ST. J., Dec. 12, 1991, at A10.
219. *Id.*
220. Hofheinz, *supra* note 180, at 62.
221. Hays, *supra* note 207.
222. Laurie Hays and Adi Ignatius, *Moscow's Capitalists' Decide the Best Price is a Firmly Fixed One*, WALL ST. J., Jan. 21, 1992, at A1.
223. *Id.*
224. Russel Watson, *et al.*, *And What Now?*, NEWSWEEK, Sept. 16, 1991, at 33.
225. Adi Ignatius, *Russians Endure a Winter of High Prices But Face More Economic Shocks in Spring*, WALL ST. J., Mar. 10, at A15.
226. Watson, *supra* note 224.

toes and fruit rot before getting to consumers.[227]

To preserve themselves, trade unions are positioned in the front of a growing popular movement of dissatisfaction.[228] The unions appeal to people angry over shortages, and seek to link wages to prices, as well as to have industry spend more of its revenue on pay.[229] However, if the republics try to buy stability by buying off workers, catastrophic hyperinflation could result and may jeopardize the whole reform movement.

Over sixty years of ethnic repression by the manipulative central planners is erupting in violence.

a. Ethnic factions in Afghanistan are warring.[230]

b. Muslim-dominated Azerbaijan intensified an embargo against mostly Christian Armenia during the week of Nov. 4, 1991, by cutting off all natural gas shipments.[231] As a result, Armenia closed all but essential factories and limited TV broadcasts to one hour per day to conserve energy.[232] The economic situation in Armenia is worsening, and as of March, 1992, no cease-fire had been negotiated.[233]

c. The Chechen-Ingush Autonomous Republic declared independence from Russia and armed a 3,000 man militia with weapons purchased from Hungary.[234]

d. The Uzbeks have ongoing feuds with people in their bordering republics of Kazakhstan and Turkmenia.[235]

There is no consensus about what to do next. Instead, the leaders of this struggling group of newly born sovereignties continue to scrap among themselves. Fighting erupted in Georgia in October of 1991 between opposition forces and supporters of President Gamsakhurdia, who was being accused of dictator-like actions since his election the previous May.[236] Thousands of Communist protestors clashed with Moscow riot police in late February of 1992, denouncing President Yeltsin.[237] The Russian Vice President, Alexander Rutskoi, has lead the opposition to Boris Yeltsin's economic policies by openly criticizing the Russian plan to liberalize

227. *Id.*

228. Neela Banerjee, *Unions Give Voice to Struggling Russians Tired of Yeltsin's Economic Promises*, WALL ST. J., Oct. 31, 1991, at A13.

229. *Id.*

230. Gerald F. Seib, *Baker Forging New Soviet Economic Ties as Issues such as Afghanistan Melt Away*, WALL ST. J., Sept. 16, 1991, at A5.

231. *Energy Crunch Slows America*, WALL ST. J., Nov. 11, 1991, at A10.

232. *Id.*

233. WALL ST. J., Mar. 19, 1992, at A1.

234. John Fialka, *Former Soviet Republics of South-Central Asia Have Nuclear Arms, Links with Volatile Lands*, WALL ST. J., Dec. 17, 1991, at A16.

235. *Id.*

236. *Violence in Georgia spawns emergency legislative session*, DENV. POST, Oct. 6, 1991, at A7.

237. *Thousands of Communists Clashed*, WALL ST. J., Feb. 24, 1992, at A1.

prices before privatizing industry.[238] Citing the same issues as Rutskoi, Moscow mayor and long-time Yeltsin ally Gavril Popov resigned in late December. A number of the elected Presidents of the smaller republics are the same Communists that lead them before, but the new freedoms have them keenly interested in developing their backward economies.[239] Indications are that they will no longer wait for leadership from the larger republics if they can establish diplomatic relations directly with the West to secure economic help.

B. *Revisiting East-West Joint Ventures Today*

The first issue that Western businesses have to consider is who to deal with. Though the emergence of fifteen new possibilities is daunting, complications may actually be lessened since the central Ministry maze will soon be nonexistent. The current joint venture deal making steps of discussion, negotiation and registration remain logical ones to continue, though registration will now likely be with a republic government. Without guidance from the Soviet central core and no precedent for many of the republics to follow, it is even more critical than before that Western partners remember and use to the benefit of the joint venture, the CIS people's love of the written word. Specificity of all conceivable venture terms in writing is a must.

Potential new developments in the eight areas of law and operations usually negotiated in a joint venture are discussed below.

1. Contribution Valuation

While the CIS Republics are struggling with how to establish a monetary system, problems with contribution valuation will not improve. The emergence of a market economy will be the main long term remedy. In the short term, Western partners should plan to continue assisting their CIS partners with valuation procedures, while using evidence of previous sales and valuations in the Eastern Bloc for foundation.

2. Profit Repatriation

The ruble is still the root of the trouble in this area, and the move to a market economy is the ultimate key to the solution. Western interests will continue to press for ways to make profits for the CIS citizenry, and this may become more likely without the central government standing guard. In the short term, counter-trade deals still appear to be the best way to convert joint venture profits into hard currency for Western repatriation. It may even continue as a long term solution if the quality of CIS produced goods improve.

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238. Elisabeth Rubinfien, *Yeltsin Deputy Opposes Plans for Economy*, WALL ST. J., Dec. 19, 1991, at A10.

239. Robert S. Greenburger, *Baker is Wooing Central Asian Republics*, WALL ST. J., Feb. 14, 1992, at A8.

3. Property Rights

Three generations of citizens have accepted the idea that the state owns virtually everything. Even as Moscow and some republics move toward private ownership of property, it is questionable how quickly such a shift can be made or if it will be made in all parts of the CIS. Ownership of things like mineral rights may be hard to sever from republic governments in cases like Afganistan, where over half of the republic's income is from natural gas sales. Western partners should watch these laws closely but be prepared to continue operations as before.

4. Financing

Continued movement on project financing can be expected since there is even less assurance that CIS partners can be held financially responsible for their part of any deal. Financiers can be expected to continue to rely heavily on the Western partner and look to the joint venture itself for their return on investment.

5. Taxes

There will likely be major shifts in tax laws as the republics rush to raise hard currency from the only existing enterprises linked to a market economy. Westerners should expect new tax laws in republics that have never had them before. Tax laws may also be issued coincidentally with laws that allow more privatization of industry. Employees may get a break, however, if the republics move to ease some of the burden their citizens are carrying due to the move toward a market economy.

6. Dispute Resolution

Arbitrazh is likely to cease to exist in its current form as a forum for dispute resolution, and use of U.S. courts hold no better promise than before. Arbitration carefully outlined in the joint venture agreement still appears to be the best alternative. Western partners should be more cautious than ever about negotiating these terms with CIS partners.

7. Labor

Labor law may have less impact than the expectations of the work force. The concept of having a right to work has long been seen as an entitlement to a present job. The power of the trade unions to control discipline and challenge management won't soon be forgotten.

Potentially, Western business partners should take cues from the General Electric Co. Tungstran factory established in Budapest, Hungary, twenty months ago. General Electric found that schools haven't prepared workers for a demand economy.[240] One Western manager gathers

240. Roger Thurow, *Seeing the Light*, WALL ST. J., Sept. 20, 1991, at R2.

his Hungarian managers every morning to see what can be learned from problems in the previous twenty-four hours. "What I often get is an eloquent detailed description of what went wrong and what the current situation is, but absolute silence about a plan to go forward to solve it," he says.[241]

General Electric has established "business made easy" courses where everyone, including janitors through executives, learns that profit is not a bad word.[242] There are sensitivity classes which teach that criticism of processes and work patterns is necessary. A weekly newsletter has replaced the sayings of Lenin with those of Lombardi; "We want to win, not just exist."[243] The going will not be easy, especially since economic pressures are likely to cost some workers their jobs. In the words of a female factory worker, "Everything belonged to the workers: the factory and the machinery. Now they just tell us to get out."[244]

8. Procurement and Quality

Transportation problems simply must be solved. This will be tricky, even if the republics negotiate open trade among themselves. How do you teach the value of good quality to people who are accustomed to standing in line to buy whatever is available? It will not be easy, but McDonald's and Pepsico's experiences show that it can be done. Pressures from meeting market demands, and the emerging awareness that people have a right to good quality, will help address these problems in the long term.

C. *Three More Barriers: The Ruble, Banking and the Law*

The worthless ruble, the nonexistent banking system, and a legal system designed to promote Communist Party goals rather than objectivity are three immense difficulties that must be attacked soon.

1. The Ruble

The ruble never served the traditional role of money. It was neither a medium of exchange, nor an item of value.[245] In September of 1991, the Soviet Union printed rubles as fast as possible for masses of transactions.[246] However, the uncontrolled printing fuelled by rising wages was not matched by increased production, and hyperinflation resulted.[247] The official exchange rate for rubles in early November of 1991 was devalued

241. *Id.*
242. *Id.*
243. *Id.*
244. Barry Newman, *Troubling Omen: Poland's Shaky Transformation to a Free Market Carries Warning for Soviets*, WALL ST. J., Sept. 13, 1991, at A10.
245. George Soros, *U.S.S.R.: See the Future, Make it Work*, WALL ST. J., Sept. 13, 1991, at A12.
246. John Lloyd, *Rubles Printed Round the Clock*, FIN. TIMES, Sept. 18, 1991, at 1.
247. *Id.*

from thirty-two rubles to the dollar to forty-seven rubles to the dollar.[248] The black market rate then was around seventy rubles to the dollar and banks got seventy seven rubles to the dollar at Moscow auctions.[249] The slide in value became a frightening plunge. But Russian central bank officials tightened credit at the beginning of the year, reduced the supply of rubles in circulation, and began a delicate support intervention. As a result, the ruble has seen some stabilization, trading at 170 per dollar in late February, 1992, up from 230 rubles per dollar at the end of January.[250]

A possible long term solution would be to enact a Russian version of the Bretton Woods system used for twenty-five years following World War II.[251] Under the system, the U.S. kept its currency convertible to gold at a fixed rate and other countries wanting to engage in the system agreed to keep the value of their own currencies in terms of the dollar at fixed rates.[252] This system provided monetary stability and promoted trade among the members.[253] Gold may be the most acceptable foundation for sound money.[254] Most important, the ex-Soviets have substantial gold holdings. CIA estimates have put the amount at about twenty-five billion dollars, which is enough to start minting coins in troy ounces.[255]

2. Banking

The problem of ruble non-convertability is heavily complicated by the lack of an efficient banking system that enables money to move easily from one section of the economy to another, for example from farming to food stores.[256] The CIS lacks savings bonds, mutual funds, checking accounts and credit cards.[257] Factories dole out payrolls in paper rubles; there is no such thing as a paycheck.[258] Since CIS citizens can't put their money to work for them, the economy lacks what is called a multiplier effect. If a U.S. consumer spends a dollar to buy milk, that money ultimately goes to pay the store clerk who uses it to buy a shirt.[259] The buck does not stop anywhere in a healthy economy.[260] What citizens do instead

248. *Soviet State Bank Plans To Further Devalue Ruble*, WALL ST. J., Nov. 4, 1991, at A16.

249. *Id.*

250. Elisabeth Rubinfien and Laurie Hays, *Suddenly Scarce Rubles Regain Value, But Not Without Moscow's Intervention*, WALL ST. J., Feb. 20, 1992, at A10.

251. Judy Shelton, *A Bretton Woods System for Ex-Soviets*, WALL ST. J., Sept. 4, 1991, at A10.

252. *Id.*

253. *Id.*

254. *Id.*

255. *Id.*

256. Penelope Purdy, *If Money Talks, Why's the Ruble so Quiet?*, DENV. POST, Sept. 15, 1991, at H1.

257. *Id.*

258. *Id.*

259. *Id.*

260. *Id.*

is stuff their pockets with rubles so, if they are walking near a shop and see something on sale, they can buy an item before the rubles devalue.[261]

The issue of banking operations will be particularly difficult since the republics have no history of managing their own spending.[262] The central bank collected all revenues and gave out what it chose in return.[263] The republics will have to learn the operation of balance sheets and a proper system of debits and credits.[264]

The International Monetary Fund (IMF), the World Bank and other similar institutions will have a special role to play by putting up both equity, as well as the knowledge and personnel resources to train and build local management.[265]

3. The Law

The Soviet legal system has been characterized by two features: inaccessibility of the laws, and dealing with the bureaucracy.[266] The legal system, because of central planning, was largely administrative with tens of thousands of internal regulations, many of which were not published.[267] Those regulations that were published were limited in number and not generally available.[268]

There is no judicial system that will enforce contracts, and the role of the lawyer has been that of an enforcer, not a deal maker.[269] A typical Soviet negotiation team prior to 1987 limited the role of lawyers to mere technicians, summoning them only when negotiations reached a technical question.[270] Lawyers had no authority to vary the text of a clause from a form book.[271]

Corporation law remains in its infancy. Under the 1987 Joint Venture Decree, the joint venture is considered a "judicial person subject to Soviet law;" there is no broader corporation law.[272] There are no publications that guide writing a valid contract, and no explanation of the legal consequences of signing a contract prior to registration with authorities.[273] It is uncertain at what point in the deal process the joint venture takes effect.

261. *Id.*
262. Laurie Hays, *Cracks Appear in Yeltsin's New Union*, WALL ST. J., Dec. 13, 1991, at A10.
263. *Id.*
264. *Id.*
265. *Let the Soviet Flowers Bloom*, FIN. TIMES, Oct. 1, 1991, at 20.
266. Richard Dean, *Practicing Law and Doing Business in the Soviet Union*, 11 N.Y.L. SCH. J. INT'L & COMP. L. 439, 441 (1990).
267. *Id.* at 442.
268. *Id.*
269. David Brooks, *The Capitalist Archipelago*, WALL ST. J., Dec. 10, 1991, at A5.
270. Dean, *supra* note 266, at 439.
271. *Id.*
272. Houri, *supra* note 3.
273. *Id.*

Workers have been consciously favored by the court in labor disputes.[274] Soviet jurists boast about this bias, saying it is a strength of their "socialist" court system.[275] In addition, courts have directions that they are to eliminate the improper labor practices they encounter and to instill in the citizenry a "communist attitude" toward work.[276] In short, they have not been a neutral forum for dispute resolution, but an important instrument of state policy.[277]

D. *Trade Continues*

Despite political upheavals, trade continues. In fact, increased trade may well be a life giving infusion to the new republics. Polariod has continued producing camera parts in a two-year joint venture despite the fact that its chief partner, the Soviet Ministry of Atomic Energy, no longer exists.[278] Coca-Cola says it will switch distribution rights for the Baltic states from Moscow to its Nordic division in Oslo.[279]

Russia's review of current oil export licenses shows that it is likely many Western agreements will remain intact.[280] By early December the licenses were to be reviewed so that fuel supplies for Russia during the winter of 1991 were assured, and that republic agreements, international agreements and treaties concluded in exchange for food, medicine or technical advice could be fulfilled.[281]

The biggest winner could be Chevron, who has been negotiating for four years to drill the huge Tenghiz field in Kazakhstan. Without Moscow's continued attempts to derail the deal, Chevron hopes to conclude it quickly with Kazakh officials.[282] Amoco negotiated a deal in June 1991 with the Soviets to allow off-shore oil explorations in the Caspian Sea in Azerbaijan.[283] The key is to now clarify which republic officials are responsible for what.[284]

Huntsman Chemical and Marriott Corp. have a joint venture with Aeroflot to produce plastic cups for the Soviet carrier's service and hope to operate a $40 million polystyrene plant in the Ukraine in partnership with a local cooperative.[285] Huntsman Chemical also opened a $2.5 million cement slab plant in Armenia in June of 1991, and hopes to open a

274. Block, *supra* note 117, at 658.
275. *Id.*
276. *Id.*
277. *Id.*
278. Thomas F. O'Boyle, *Soviet Breakup Stymies Foreign Firms*, WALL ST. J., Jan. 23, 1992, at B1.
279. Seib, *supra* note 230.
280. Rubinfien, *supra* note 183.
281. *Id.*
282. Hofheinz, *supra* note 180, at 68.
283. *Id.*
284. *Id.*
285. Tim Ferguson, *Container Giant Isn't Insulated from Soviet Spills and Chills*, WALL ST. J., Sept. 3, 1991, at A15.

building block operation there soon.[286]

The need for new communications systems is critical throughout the CIS. AT&T sold a sophisticated digital-switching system to the Armenian government in late 1991,[287] and in February of 1992 formed a joint venture with a Russian telephone equipment manufacturer to adopt AT&T's network equipment for use in Russia.[288] AT&T also recently signed a pact with the Ukraine to build and operate a new telephone network.[289]

A newly formed Russian trade group created a business center in New York in mid-December 1991 to link U.S. businesses with their privately owned Russian counterparts.[290] The intent is to ensure that Russian enterprises will have direct access to American markets.[291] A similar endeavor opened in Washington in October of that same year to link U.S. entrepreneurs with Moscow companies.[292]

VI. CONCERNS ABOUT THE COMMONWEALTH

James Madison came to Philadelphia in May of 1787 to expose the "vices" of confederations. They are inherently ineffectual since they are based on principles of local sovereignty and a weak central government.[293] Both a Constitution and a civil war were needed before the United States stabilized.

It seems the new CIS republics may be destined to repeat the American past. Fundamental power is in the hands of the republics. This creates a number of political anomalies; for example the six Muslim republics will be in a position to outvote Russia, despite Russia's possession of half the CIS's population. The likelihood of cohesive action on common interests, such as trade, is diminished.[294] Destruction of the union is a reality that the republics have created, and they must endure it just as Americans did. The question is whether they will eventually realize the interests they have in common despite the myriad ethnic, ideological and historical conflicts.[295]

VII. CONCLUSION

This essay has charted the recent developments in East-West business relations related to joint ventures, the emerging social reform of the

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286. *Id.*

287. John J. Keller, *AT&T Sets Accord to Adapt, Sell Gear in Russia*, WALL ST. J., Feb. 13, 1992, at A4.

288. *Id.*

289. *Id.*

290. Neil Barsky, *Business Center to Link Russian and U.S. Firms*, WALL ST. J., Dec. 16, 1991, at C13.

291. *Id.*

292. *Id.*

293. Peter McGrath, *Articles of Disunion*, NEWSWEEK, Sept. 16, 1991, at 45.

294. *Id.*

295. *Id.*

CIS republics, and attempted to project future developments that Western joint venture partners may encounter. The complexity and magnitude of the problems facing the CIS cannot be over estimated. Nations impoverished by the Soviet experiment need to focus on economic revitalization, and on channeling long suppressed energies into economic production. Joint ventures with Western partners will quite likely remain a major part of that effort.

S. Jan Vukovich

APPENDIX

Republic	Pop. (M.) % USSR	Size (Sq. mi.) % USSR	Resources
Russia	147 M 50.8%	6,590,950 76.0%	Iron, coal, oil, gold, platinum, copper, zinc, rare metals
Ukraine	51.4 M 17.9%	233,144 2.6%	Coal, iron, chemicals, rich farm land
Uzbekistan	19.8 M 6.6%	172,542 1.9%	Oil, gas, coal, copper
Kazakhstan	16.4 M 5.6%	1,048,762 12.0%	Coal, oil, zinc, tungsten, copper, manganese, lead
Belorussia	10.1 M 3.5%	80,288 .9%	Peat, timber
Azerbaijan	6.8 M 2.3%	33,582 .38%	Oil, gas, iron, bauxite, copper zinc, gold, silver
Georgia	5.4 M 1.8%	27,020 .31%	Coal, oil, timber, manganese
Tadzhikistan	4.8 M 1.7%	55,198 .63%	Coal, oil, lead, zinc, rare elements
Moldavia	4.2 M 1.5%	13,464 .15%	Lignite, gypsum
Kirgizia	4.1 M 1.4%	76,814 .88%	Oil, timber
Lithuania	3.6 M 1.3%	25,090 .29%	Timber, peat, amber
Armenia	3.4 M 1.2%	11,580 .13%	Copper, zinc, bauxite
Turkmenistan	3.5 M 1.2%	188,368 2.2%	Oil, coal, sulphur, magnesium
Latvia	2.6 M .9%	24,704 .28%	Peat, amber
Estonia	1.6 M .6%	17,370 .2%	Oil shale, timber

Freedom of Speech and Flag Desecration: A Comparative Study of German, European and United States Laws*

I. Introduction

In 1990, the German Federal Constitutional Court (*Bundesverfassungsgericht*, or "BVerfG") decided whether desecration of the German flag was protected by the constitutional right of freedom of speech, specifically by artistic freedom.[1] The European Court of Human Rights in 1988 dedided if three paintings of a Swiss artist were protected by the right of freedom of speech as granted in Article 10(I) of the European Human Rights Convention ("MRK").[2] In 1989 and 1990, the U.S. Supreme Court determined twice, in *Texas v. Johnson*,[3] and in *U.S. v. Eichmann*,[4] whether it was necessary to limit the First Amendment right of freedom of speech to protect the American flag and its symbolic value.

This article examines the German, European and American approaches to freedom of speech. Each subsection discusses the relevant constitutional provisions and law which applies in the respective jurisdictions. This is followed by an analysis of the leading cases to show how the law has been interpreted. The fifth section compares the different concepts. Although the laws are similar, the interpretation by the U.S. Supreme Court is the most liberal.

II. The German Approach

A. *Freedom of Speech Protected by the German Constitution (Grundgesetz)*

1. Article 5, Paragraph 1

The German Constitution (*Grundgesetz*, or "GG") of May 23, 1949, consists of 146 Articles. The procedural and substantive basic rights (Grundrechte) are enumerated in GG Articles 1 through 19. GG Article 93(I)(4a) specifies basic rights, and GG Article 5 grants the right of freedom of expression (*Recht der freien Meinungsaeusserung*). GG Article

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* A table of abbreviations used in this article appears following the text, at page 491.

1. BVerfG, Judgment of March 7, 1990, 1 BvR 266/86, 913/87, 32 N.J.W. 1982 (1990).

2. Joachim Wuerkner, *Kunst und Moral — Gedanken zur "Fri-Art 81" — Entscheidung des Europaeisehen Gerichtshofs fuer Menschenrechte*, 6 N.J.W. 369 (1989), *citing* EGMR (Art. 19, 38 ff. MRK).

3. 491 U.S. 397 (1989).

4. 496 U.S. 310 (1990).

5(I) specifically provides: "Everyone shall have the right freely to express and disseminate his opinion by speech, writing and pictures and freely to inform himself from generally accessible sources. Freedom of the press and freedom of reporting by means of broadcasts and films are guaranteed. There shall be no censorship."[5]

GG Article 5(I), then, grants freedom of expression, which includes freedom of speech, and freedom of information, freedom of the press, freedom of radio and film, and prohibits censorship. The freedom of expression broadly granted in GG Article 5(I), in the first half of the first sentence, however, is strictly limited by GG Article 5(II).

2. Article 5, Paragraph 2

GG Article 5(II) specifies, "These rights are limited by the provisions of the general laws, the provisions of law for the protection of youth, and by the right to inviolability of personal honor."[6] In Germany, there is no generic term for a general law or statute. In Germany a statute is not a general one if it is directed against a specific opinion.[7] For example, Section 11 of the Statute of October 21, 1878, directed against activities of Social Democrats, was not considered to be a general statute.[8]

There are, however, exceptions — statutes which are constitutional without qualifying as general statutes which limit the basic rights protected by GG Article 5(I)(1) and (2). For example, German Penal Code (*Strafgesetzbuch*, or "StGB") § 86(I)(4), Prohibition of Distribution, Production and Importing of Goods Used to Propagate Nazi Ideology,[9] is directed against a specific opinion; however, these statutes are held constitutional because of the preference of the protection of the free democratic basic order (*Freiheitlich demokratische Grundordnung*, or "FDGO") of Germany. Furthermore, there is no generally applicable statute when the statute, without aiming at a specific opinion, impacts only on a basic right named in GG Article 5(I)(1) and (2).[10]

The term "general laws" covers regulations based on statutory authorization.[11] The statutory law for the protection of youth must be created to protect the young and must be suited to such protection.[12] The

5. GRUNDGESETZ [GG] art. 5 I (F.R.G) [The Basic Law of the Federal Republic of Germany] (1970), [hereinafter BASIC LAW translation].

6. *Id.* at art. 5(II).

7. 20 BSGE 178.

8. RGBl 351 (1878).

9. *Compare* BGH, N.J.W. 1693 (1970); Kohlmann, *Verfassungswidrige Parteien fuer immer mundtot?* J.Z. 681 (1971); Greiser, *Verbreitung verfassungsfeindlicher Propaganda (Die Rechtfertigungsgruende des Paragraphen 86 III StGB)*, N.J.W. 1556 (1972); OLG Celle MDR 941 (1970).

10. Ridder, *Anmerkung zu BVerfG, Beschluss vom 25.01.61 - 1 BvR 9/57, GG Art 5 I,II, StGB Paragraph 193*, J.Z. 539 (1961); Bettermann, *Die allgemeinen Gesetze als Schranken der Pressefreiheit*, J.Z. 604 (1964).

11. OVG Muenster DVBl 509 (1972).

12. 30 BVerfGE 354.

law of personal honor has the power to limit freedom of speech only so far as it is statutory law.[13]

3. Article 5, Paragraph 3

GG Article 5(III) states: "Art and science, research and teaching, shall be free. Freedom of teaching shall not absolve one from loyalty to the constitution."[14] This Article grants broad freedom for art and science, research and teaching. The freedoms granted by this section are not limited by the provision of GG Article 5(II), which limits the various rights of freedom of expression as specified in GG Article 5(I). Following the plain meaning of GG Article 5(III), the freedom of expression in an artistic form arguably could not be touched or sanctioned based on any general statute or other statutory law mentioned in GG Article 5(II). Therefore, if freedom of expression takes an artistic form, it might be unrestricted.

B. *Freedom of Speech Limited by Section 90a, German Penal Code (Strafgesetzbuch)*

A conflict arises if acts exercised under the right of freedom of expression clash with regulations of the penal code. Section 90(a)(I) of the German Penal Code (StGB) states:

> Whoever publicly, in an assembly, or by disseminating publications or writings . . . 1. insults or maliciously scorns the Federal Republic of Germany or one of its states, or its constitutional order, or 2. desecrates the colors, the flag, the coat of arms or the anthem of the Federal Republic of Germany or one of its states, shall be punished with imprisonment for up to three years, or shall be fined.[15]

Section 90(a) StGB is one of the regulations in the third title of the German Penal Code, "Endangerment of the Democratic Constitutional State."[16] These regulations have been created to focus on endangerment of interior state security. They are designed not only to protect against subversive actions, illegal propaganda, and demoralization of the security institution, but also to prevent the Federal Republic and its institutions from disparagement.[17] The values protected by Section 90(a)(I)(1) StGB are the existence of the state and the existence of the constitutional order in the sense of the free democratic basic order (FDGO).[18]

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13. 33 BVerfGE 17.
14. BASIC LAW translation, *supra* note 5, at art. 5(III).
15. Author's translation of the German Penal Code § 90(a).
16. *Id.*
17. Wuertenberger, *Kunst, Kunstfreiheit und Staatsverunglimpfung (Paragraph 90a StGB)*, J.Z. 309, 311 (1979) (with reference to SCHOENKE-SCHROEDER, STRAFGESETZBUCH, KOMMENTAR (19th ed. 1978), preface to §§ 80 *et seq.*).
18. *Id.* at 311.

C. *Decision of the German Federal Constitutional Court (Bundesverfassungsgericht), March 7, 1990*

1. Facts

In 1990, the German Federal Constitutional Court (BVerfG) had to decide the question of whether an illustration on the cover of a book was protected by the constitutional right of freedom of speech, or more specifically, by the right of artistic freedom, as granted in GG Article 5(III).[19]

In 1981 and 1982, the managing director of a literature distribution company sold several copies of the book *Lasst mich bloss in Frieden* (Leave Me In Peace). The book contained, besides cartoons and collages, anti-militaristic prose and poetry.

The book's front cover depicted a soldier with a skull and a steel helmet; the back cover depicted two pictures which formed a collage. The lower portion of the collage showed a black-and-white picture of an oath ceremony of the German armed forces in which soldiers held an unfolded German flag. In the background was a barracks building. In front of that building, a soldier was standing on a podium which was decorated with a German flag. Between this soldier and the barracks was a flagpole with a German flag flying. The sky over the barracks formed the background of the color picture, which was the upper half of the collage. The collage showed a male human torso, wearing a shirt and pants from the knees to the hips, rising like a giant behind the roof of the barracks. The open fly was concealed by the man's right hand in urinating position. Behind the hand, a stream of urine was directed onto the unfolded flag in the lower picture. Under the flag on the ground, a yellow puddle of urine was evident.

2. Procedural Posture

The trial court (*Amtsgericht*) fined the managing director of the literature distribution company 4500.00 German Marks. The court held the back cover of the book to be a desecration of the colors and the flag of the Federal Republic of Germany.[20] The highest appellate court for this case, the *Oberlandesgericht* (OLG), dismissed the managing director's appeal.[21]

Based on his rights granted by Article 93(I)(4)(a),[22] the managing director called on the Federal Constitution Court, claiming that his basic right of freedom of expression, here the right of artistic freedom, was vio-

19. BVerfG, Judgment of March 7, 1990, 1 BvR 266/86, 913/87, 32 N.J.W. 1982 (1990).
20. *Id.*
21. OGL Frankfurt 84 NStZ 120.
22. GG art. 93(I)(4)(a) grants everyone the right to call on the Federal Constitutional Court claiming that his basic rights, as granted by GG arts. 1-19, or one of his rights under arts. 20(IV), 33, 38, 101, 103 and 104, have been violated by the State. However, all other possible judicial remedies must be exhausted within the courts of ordinary jurisdiction.

lated by the criminal prosecution and sentencing.[23]

3. The Court's Decision

Though the Court held that the appealed decisions violated the director's constitutional rights, the Court declared that GG Article 5(III)(1) does not prevent someone from being punished under Section 90(a)(I)(2) of the German Penal Code (StGB) for desecration of the German flag, even when used in an artistic form.[24]

a. Illustration is Art

The Court held the illustration on the back cover of the book, *Lasst mich bloss in Frieden* (Leave Me In Peace), to be art even though the illustration was offensive. Art is free from State control of style and standard.[25] This classification, however, does not prevent punishment under Section 90(a)(I)(2) StGB for desecration of the German flag, because that criminal statute was instituted to shield a constitutionally-protected value.[26] In this case, however, the Court held that the necessary weighing of the conflicting constitutional values had not been done properly and, in part, an adequate understanding of that specific piece of art had been lacking.[27]

By adding two realistic situations, the author made a certain statement that could and had to be interpreted artistically.[28] The fact that the artist wanted to express a certain opinion with his product did not preclude the protection of GG Article 5(III)(1) because it is the more specific norm.[29]

b. Artistic Freedom Does Not Protect from Punishment

The Court went on to state that, although artistic freedom is granted unreservedly, it does not generally preclude punishment for violation of Section 90(a)(I)(2) StGB. The guarantee of GG Article 5(III)(1) is not only limited by the constitutional rights of third persons, but can also collide with various constitutional regulations[30] because an orderly coexis-

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23. The BVerfG decided that case, along with another case (1 BvR 913/87), against an editor of a journal who had reprinted the back cover of the book, *Lasst mich bloss in Frieden*, with the incriminating collage. The editor had been fined 900.00 DM for desecration of the State and its symbols. The editor's subsequent appeal (*Berufung*) and his additional appeal (*Revision*) had been dismissed. The editor also called on the BVerfG. The Court did review both cases together and drew the same conclusion. The author focuses here on the case 1 BvR 266/86 to avoid repetition.

24. BVerfG, Judgment of March 7, 1990, BvR 266/86, 913/87, 32 N.J.W. 1983 (1990).

25. *Id.* (with reference to 75 BVerfGE 369, 377).

26. *Id.*

27. *Id.*

28. *Id.* (with reference to 30 BVerfGE 173, 189).

29. *Id.* (with reference to 30 BVerfGE 173, 200 and 75 BVerfGE 369, 377).

30. *Id.* (with reference to 30 BVerfGE 173, 193 and Lerche, *Schranken der Kunstfreiheit - Insbesondere zu offenen Fragen der Mephisto-Entscheidung*, BayVBl. 177, 180-181 (1974)).

tence of the people requires not only mutual consideration of everyone, but also a functioning public State order which secures the efficiency of the protection of constitutional rights.

Works of art which undermine the constitutionally-granted order are not limited only if they endanger the existence of the State or the Constitution. When other constitutional values are in conflict with expression under artistic freedom, there must be a balance between the contradictory, equally constitutionally-protected interests.[31]

c. The Conflicting Constitutional Values

The Court held that artistic freedom was in conflict with the protection of the symbols of the State. Section 90(a)(I)(2) StGB protects the German flag as a State symbol. GG Article 22 expressly determines the colors of the German flag only, but presupposes the right of the State to present itself in symbols. The purpose of these symbols is to appeal to the State consciousness of its citizens.[32]

Germany, as a free State, is dependent on its citizens' identification with the basic values symbolized by the flag. These protected values are symbolized by the colors prescribed in GG Article 22. The colors represent the free, democratic basic order (FDGO). If the flag serves as an important medium of cohesion, the desecration of the flag can undermine the State's authority which is necessary for the State's internal peace. This means that State symbols are protected by the constitution only insofar as they symbolize what is fundamental for Germany.[33]

Focusing on GG Article 5(III)(1), however, the protection of the State's symbols is not allowed to immunize the State against criticism and even rejection. It is necessary, therefore, in each case to weigh the contradictory constitutional values.[34] In this case, the Court concluded that the decision against the managing director did not meet these constitutional requirements and held the judgment against him as a violation of his constitutional rights.[35]

The Court held that the Appellate Court (OLG) did not treat the collage correctly. Since it is typical for artists to exaggerate and distort, it is necessary to look beyond the satirical words and pictures to determine the collage's real content.[36] The Court held that the Appellate Court misinterpreted the real content of the collage, holding the real content to be

31. *Id.* (with reference to 77 BVerfGE 240, 253).

32. *Id.*; Wuertenberger, *supra* note 17, at 311 (referring to H. KRUEGER, ALLGEMEINE STAATSLEHRE 226 (1965)).

33. *Id.*

34. *Id.*

35. *Id.* In another decision on the same day, the Federal Constitutional Court held that GG Article 5(III)(1) does not generally preclude punishment under Section 90(a)(I)(2) StGB for desecration of the German national anthem, BVerfG, Beschluss from March 7, 1990, 1 BvR 1215/87, 32 N.J.W. 1985 (1990).

36. *Id.* at 1984 (with reference to 62 RGSt 183, 75 BVerfGE 369, 377).

the desecration of the flag and the State, which is symbolized by the flag. The Court found, however, that although the collage shows a State symbol's defamation, it was not intended to attack the state or the democratic basic order of the Federal Republic of Germany. Instead, the criticism was directed mainly against militarism in Germany, and the State was attacked only because it was enforcing the military draft and legitimizing the draft by using the State's symbols at the oath ceremony.[37] The Court concluded that because more freedom is given to the satirical distortion than to its content, the OLG's misinterpretation of the collage caused a violation of the constitution.[38]

Though in this particular case the Court found that the acts were constitutionally protected, the judges held that freedom of expression as granted in GG Article 5(III) does not generally preclude punishment under Section 90(a)(I)(2) StGB.[39]

4. Consequences of the Court's Opinion

The Court's decision was severely criticized in Germany, especially the determination by the Court of which values were constitutionally protected so that they could be used to limit the freedom of expression as granted by GG Article 5(III), though the constitution should determine these protected values.[40] The German flag was mentioned in GG Article 22, but not expressly protected.[41]

The deciding term "desecration" in the German Penal Code as used in Section 90(a) StGB was held by critics as unclear,[42] and not interpreted by any of the various courts which were involved in the flag desecration case. Therefore, the Court's decision of March 7, 1990, was held to be more sibyllinic than solomonian.[43]

It seems dangerous when the rule allowing freedom of expression as granted in GG Article 5(III), to be limited by "constitutionally-protected values" only, is annulled by the Federal Constitutional Court by valuing any statutorily-accepted or by the State-accepted concern to be a "constitutionally-protected value."

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37. *Id.*

38. *Id.*

39. *Id.* at 1983.

40. Christoph Gusy, *Anmerkung zu BVerfG, Beschluss v. 7.3.1990 -1 BvR 266/86 und 913/87*, J.Z. 640, 641 (1990) (with reference to CHRISTOPH GUSY, PARLAMENTARISCHER GESETZGEBER UND BVERFG 65 (1985)).

41. *Id.*

42. *Id.* (with reference to BEMMANN AND MANOLEDAKIS, DER STRAFRECHTLICHE SCHUTZ DES STAATES 107 (1987)).

43. Gusy, *supra* note 40, at 641.

III. THE EUROPEAN APPROACH

A. *Freedom of Speech Protected by the European Convention on Human Rights*

Freedom of speech is protected in Western Europe not only by the national laws of the European nations, but also by the European Convention on Human Rights (MRK),[44] which has been ratified by twenty-one western European nations.[45]

By accession to the Convention, the nations guarantee their citizens and residents the Convention's rights and freedoms.[46]
Freedom of speech is granted by MRK Article 10(I).[47] Freedom of speech under the Convention consists of freedom of forming an opinion, freedom to express an opinion, and freedom to receive information.[48]

When a right or freedom granted by the Convention is violated, the encumbered person or legal entity is entitled to call upon the European Commission of Human Rights ("Commission") for a decision. The Commission was formed by the contracting States under Article 19 (a) of the MRK. The Commission is entitled to accept a matter only after exhaustion of all intra-state legal remedies of an encumbered party.[49]

If the Commission concludes that the named state violated its obligations under the Convention, and mediation by the commissioner, as pre-

44. Several nations have made reservations and declarations regarding specific provisions of the Convention at the time of ratification, acceptance, approval or accession to the Convention.

45. The ratifying nations include the twelve member countries of the European Community: Federal Republic of Germany, Belgium, Denmark, France, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom. The other Contracting States to the MRK are: Iceland, Liechtenstein, Malta, Norway, Austria, Sweden, Switzerland, San Marino, Turkey and Cyprus.

46. MRK art. 1.

47. Article 10 of the Convention states:

> (1) Everyone has the right to freedom of expression. This right shall include freedom to hold opinions and to receive and impart information and ideas without interference by public authority and regardless of frontiers. This Article shall not prevent States from requiring the licensing of broadcasting, television or cinema enterprises.
>
> (2) The exercise of these freedoms, since it carries with it duties and responsibilities, may be subject to such formalities, conditions, restrictions or penalties as are prescribed by law and are necessary in a democratic society, in the interests of national security, territorial integrity or public safety, for the prevention of disorder or crime, for the protection of health or morals, for the protection of the reputation or rights of others, for preventing the disclosure of information received in confidence, or for maintaining the authority and impartiality of the judiciary.

MRK art. 10.

48. FROWEIN AND FROWEIN-PEUKERT, EUROPAEISCHE MENSCHENRECHTS-KONVENTION, art. 10 n. 2.

49. MRK art. 26.

scribed by MRK Article 28, fails, the Commission calls for a decision by the European Court of Human Rights.[50] The decision of the European Court of Human Rights is final, and the Contracting States are obligated to obey the Court's decision.[51]

B. *The Case of Josef Felix Mueller*

1. Facts

In 1988, the European Court of Human Rights decided the question of whether the exhibition of three paintings of the Swiss artist, Josef Felix Mueller, which were exhibited in the city of Fribourg in Switzerland, were protected by the right of freedom of speech as granted in Article 10 I of the European Convention on Human Rights.

In the fall of 1988, the artist created three monumental paintings entitled *Drei Naechte, drei Bilder* (Three Nights, Three Paintings) at the art exhibition "Fri-Art 81" in Fribourg. The local authorities in Fribourg decided that the paintings emphasized extreme forms of sexuality and confiscated the paintings. The authorities believed the paintings severely injured the morals of the average Swiss citizen and consequently prosecuted the artist.

2. Procedural Posture

a. Earlier Cases

Although the Swiss Constitution of May 29, 1874,[52] does not contain an explicit, fundamental right of freedom of speech in an artistic form, the Swiss Federal Court in 1962 extended freedom of speech as an unwritten, fundamental right of the Swiss Federal Constitution with respect to the creation of art.[53]

Twenty years later, however, a criminal court in Zurich[54] sentenced

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50. The European Commission of Human Rights was established by the Contracting States under MRK art. 19(b). The European Court of Human Rights is the second European Court. The European Court of Justice, established under Article 4 of the Treaty establishing the European Community (Treaty of Rome, 1957), insures uniformity in the interpretation and application of the Community law. Treaty of Rome art. 164. The Court of Justice does not have jurisdiction regarding the acts of states which are not members of the European Community but are Contracting States of the European Convention on Human Rights. The European Court of Human Rights is seen by some jurists as the future European Constitutional Court; *see, e.g.*, WEIDMANN, DER EUROPAEISCHE GERICHTSHOF FUER MENSCHENRECHTE AUF DEM WEG ZU EINEM EUROPAEISCHEN VERFASSUNGSGERICHTSHOF (1985). *See also* Lang, *The Development of European Community Constitutional Law*, 25 INT'L LAW. 455 (1991).

51. MRK art. 52.

52. Bundesverfassung der Schweizerischen Eidgenossenschaft.

53. Judgment of September 19, 1962 of the Swiss Federal Court (*Schweizer Bundesgericht*), 64 ZBl 363, 365 (1963).

54. Obergericht Zuerich.

Harald Naegeli, "the Sprayer of Zurich," to nine months imprisonment and a fine of 100,000 Swiss Francs. From 1977 to 1979, Harald Naegeli secretly sprayed figures on hundreds of public and private buildings in the city of Zurich. The figures had a distinctive style and were held by various Swiss art critics to be an important form of art. After his arrest, Naegeli stated that he believed his figures were an artistic message to society.[55] Naegeli was found guilty of repeated property damage[56] under Article 145(I) of the Swiss Penal Code.[57]

b. Application to Mueller

Josef Felix Mueller was prosecuted under a provision of the Swiss Penal Code[58] which outlaws obscene publications. He was convicted by the Court of First Instance Saanen.[59] Mueller appealed to the Appellate Court Fribourg[60] without success and brought another appeal to the Swiss Federal Court.[61] The Swiss Federal Court dismissed the appeal, and the artist filed a suit in the European Court of Human Rights against Switzerland for violation of his right of freedom of speech as granted by Article 10 I MRK.

3. Holding of the European Court of Human Rights

The European Court of Human Rights relied in its decision in the matter of Mueller on its previous opinion in the Handyside Case.[62] The Commission, in its report under MRK Article 31, declared the expression of artistic freedom as of fundamental importance in a democratic society. By means of his creative work, the artist not only expresses his personal view of life, but also his thoughts about the society in which he lives. Artistic expression not only furthers education, but also furthers expression of public opinion. Furthermore, the artistic presentation may initiate a public discussion of the important issues of the time.[63]

In the Handyside Case, the European Court of Human Rights had to decide whether authorities of the United Kingdom had exceeded their discretion in seizing the alleged obscene publication entitled "The Little

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55. Hoffman, N.J.W. 237 (1985); M. MUELLER, DER SPRAYER VON ZUERICH, SOLIDARITAET MIT HARALD NAEGELI (1984). Harald Naegeli appealed the decision of the Swiss Federal Court to the European Court of Human Rights, but the Commission dismissed the case. The reasoning of the Commission was that freedom of speech in an artistic form does not extend to the damage of others' personal property for the purpose of expression of artistic freedom. N.J.W. 2753 (1984); EuGRZ 259, 260 (1984); P.C. RAGAZ, DIE MEINUNGSAEUSSERUNGSFREIHEIT IN DER MENSCHENRECHTSKONVENTION (1979).

56. Sachbeschaedigung.

57. Swiss STGB (Schweizerisches Strafgesetzbuch).

58. Swiss STGB art. 204.

59. Bezirksstrafgericht Saanen.

60. Kantonsgericht Fribourg.

61. Schweizerisches Bundesgericht.

62. Eur. Ct. H.R., Judgment of December 7, 1976.

63. Wuerkner, *Kunst und Moral-Gedanken zur "Fri-Art-81": Entscheidung des Europaeischen Gerichtshof fuer Menschenrechte*, N.J.W. 369, 371 (1989).

Red Schoolbook" and in prosecuting its publisher, Richard Handyside, under the 1959-1964 Obscene Publications Act which resulted in his conviction and seizure and confiscation of the book.[64]

The Court observed that it was not possible to find, in the domestic law of the various Contracting States to the European Convention on Human Rights, a uniform European concept of morals.[65] Countries' respective laws of the requirements of morals vary in time and place, especially in modern times which are characterized by a rapid and far-reaching evolution of opinions. According to the Court, by reason of their direct and continuous contact with the vital forces of their countries, national authorities are in a better position than international judges to give an opinion on the exact content of these requirements, as well as on the "necessity" of a "restriction" or "penalty" intended to meet these requirements.[66] National authorities must make the initial assessment of the realities of the pressing social need implied by the notion of "necessity" in this context. Consequently, MRK Article 10(II) leaves the Contracting States a margin of appreciation.[67]

The Court further observed that it is not its task to replace competent national courts, but rather to review under MRK Article 10 decisions delivered in exercise of the courts' power of appreciation. However, the European Court's supervision would generally prove illusory if it did no more than examine these decisions in isolation; it must view them in light of the case as a whole, including the alleged obscene publication in question and the arguments and evidence adduced by the applicant in the domestic legal system, and then decide, on the basis of the different data available to it, whether the reasons given by the national authorities to justify the actual measures of "interference" taken are relevant and sufficient under MRK Article 10(II).[68]

In the Handyside Case, the Court held that freedom of speech is a cornerstone of a democratic society, an important condition for its progress and for individual self-realization.[69] The Court emphasized that freedom of speech applies to inconvenient views, to views that provoke, shock or bother the State or a part of the population.[70]

In the case of Josef Felix Mueller, the Court followed its opinion in the Handyside Case. The Court extended freedom of expression under MRK Article 10(I) to artistic expression of opinions, including those opinions which provoke, shock or disturb. Pluralism, tolerance and liberality are necessary for a democratic society: "Those who create, interpret,

64. Eur. Ct. H.R., EuGRZ 38, 42 (1976).

65. ZAIM M. NEDJATI, HUMAN RIGHTS UNDER THE EUROPEAN CONVENTION 186 (1978).

66. *Id.*

67. *Id.*

68. *Id.*

69. Eur. Ct. H.R., EuGRZ 38, 42 (1976); *see also* BERGER, RECHTSPRECHUNG DES EUROPAEISCHEN GERICHTSHOF FUER MENSCHENRECHTE 79 (1987).

70. Eur. Ct. H.R., EuGRZ 38, 42 (1976).

distribute or exhibit works of art contribute to the exchange of ideas and opinions which is essential for a democratic society. Hence, the obligation on the State not to encroach unduly on their freedom of expression."[71]

The Court focused on the limitations of freedom of expression as provided for in MRK Article 10(II), holding that Mueller's criminal convictions under the Swiss Penal Code were "prescribed by law"[72] and were necessary "for the protection of morals and the rights of others."[73]

The Court had to decide the question of whether or not the restriction of the right granted by MRK Article 10(I) was "necessary in a democratic society."[74] In answer, the Court held that artists and others who support the artist's work are limited by the restrictions of MRK Article 10(II): whoever exercises these freedoms carries duties and responsibilities. The reach of these duties and responsibilities depends on the artist's situation and the media he used. The Court held that it had to review the duties and responsibilities in order to answer the question of whether or not a conviction was necessary in a democratic society.[75]

The Court then weighed individual artistic freedom against the protection of morals.[76] The Court stated that in 1988, it was still impossible to find a common European view of morals in the social and legal order of the Contracting States to the European Convention on Human Rights. Therefore, the public authorities are generally, by means of their direct and continuous contact with their countries' people, better equipped to judge the specific meaning of the duties and responsibilities, and also to judge the necessity to restrict the exercise of the freedoms and to decide on a penalty to obtain the restriction.[77]

The Court thereby granted the Contracting States wide discretion in judging the necessity of restricting the right of freedom of expression. The Court concluded that Josef Felix Mueller's conviction was necessary for the protection of morals of the Swiss population and other visitors to the exhibition.[78]

C. *Freedom of Speech Protection in States which Adopted the European Convention on Human Rights Compared with German Intra-State Protection*

The European Court of Human Rights focused in Mueller's case on the criteria of duties and responsibilities as provided for in MRK Article 10(II). However, it may be a heavy burden on the artist to think about his

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71. Eur. Ct. H.R., EuGRZ 543, 545 (1988); N.J.W. 379 (1989).
72. MRK art. 10 II, criterion 1.
73. *Id.* at criterion 2.
74. *Id.* at criterion 3.
75. Eur. Ct. H.R., EuGRZ 543, 545 (1988).
76. *Id.*
77. *Id.*
78. *Id.*

duties and responsibilities while he is creating a piece of art. The Court was criticized for infringing upon the creativity of artists.[79]

The German Federal Constitutional Court has a different approach in reviewing the limitation of artistic freedom, acknowledging in its decisions that there are peculiarities in the field of art which have to be considered when the courts review the limits of freedom of expression in the arts.[80] For example, in its so-called "Cartoon Decision" in 1977,[81] the German Federal Constitutional Court had to decide whether or not a cartoon published in a magazine, which showed a high-ranking German politician as a copulating pig, was protected by the constitutional right of freedom of expression under Article 5 of the German Constitution.[82] The artist was fined for defamation[83] by a criminal court of first instance.

The Federal Constitutional Court held the cartoons to be art as stated in GG Article 5(III).[84] Though the Court found it impossible to generally define what art is, it held it necessary to differentiate between what constitutes art and what does not, and define the basic requirements for a work to be considered art in applying GG Article 5(III).[85] A differentiation between higher and lower, or better or worse, art was held not to be allowed by the Court. Such a differentiation would be considered an illegal censorship of the content.[86]

The Court considered the cartoons to be the product of a free, creative process in which the artist expressed his views, impressions and experiences.[87] The Court, therefore, held that the cartoon met the requirements essential for artistic activity.[88]

The fact that the artist expresses a certain opinion with the cartoons does not change the fact that the cartoons are art.[89] The Court further held that art, and the expression of an opinion, are not mutually exclusive; an opinion could — as is normally a fact in art with a political theme — be expressed as art.[90] The Court viewed GG Article 5(III)(1) to be the governing basic right.

Though the Court held the cartoons to be art, it found that the personal rights of the politician, who was the subject of the cartoons, out-

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79. Wuerkner, *supra* note 63.
80. 30 BVerfGE 173, 191.
81. Karikatur-Beschluss.
82. 75 BVerfGE 369.
83. StGB § 185.
84. Wuerkner, *supra* note 63, at 377.
85. *Id.*
86. *Id.* (with reference to SCHOLZ, MAUNZ, DUERIG, GRUNDGESETZ KOMMENTAR, n. 39 (1983); GG art. 5(III)).
87. *Id.*
88. *Id.* (with reference to 67 BVerfGE 213, 226 and 30 BVerfGE 173, 200).
89. *Id.*
90. *Id.* (with reference to SCHOLZ, MAUNZ, DUERIG, GRUNDGESETZ KOMMENTAR, n.13 (1983); GG art. 5(III)).

weighed the artist's freedom of expression.[91] Even though exaggerations were typical for cartoons, and were directed toward a public figure, the cartoons were not protected by artistic freedom.[92] The Court found that the cartoons were directed against the personal honor of the politician, which is protected by GG Article 1(I).[93] The German Federal Constitutional Court held in previous cases that if someone's personal honor is impaired, there is a severe injury to his personal rights. The commission of this injury is not protected by artistic freedom.[94]

In its "Cartoon Decision," and also in its "Anachronistic March Decision,"[95] the German Federal Constitutional Court respected the arts' peculiarities and considered them in its decision process. The Court does not take recourse, as does the European Court of Human Rights, to the duties and responsibilities of the artist while he is in the process of being creative, and thereby grants the artist a greater amount of freedom in the creative process.

IV. THE UNITED STATES APPROACH

A. *Freedom of Speech Protected by the First Amendment of the Constitution*

Freedom of speech in the United States of America is protected by the First Amendment of the United States Constitution.[96] Though the First Amendment literally forbids the abridging of freedom of "speech," the United States Supreme Court has long recognized that its protection does not end with the spoken or written word, and that it also includes conduct.[97]

B. *The Case of* Texas v. Johnson

In 1989, the U.S. Supreme Court had to decide, in the case of *Texas v. Johnson*,[98] whether it was necessary, in order to protect the American flag and its symbolic value, to limit the First Amendment right to freedom of speech. After publicly burning an American flag as a means of political protest, Gregory Lee Johnson was convicted of desecrating a flag in violation of the Texas Penal Code.[99] After a trial, Johnson was con-

91. *Id.* at 379.
92. *Id.*
93. *Id.*
94. *Id.* at 380 (with reference to 67 BVerfGE 213, 228).
95. ANACHRONISTISCHER ZUG (1980), 67 BVerfGE 213, 224.
96. U.S. CONST. amend. I: "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the government for redress of grievances."
97. *See e.g.*, Spence v. Washington, 418 U.S. 405 (1974).
98. Texas v. Johnson, 491 U.S. 397 (1989).
99. TEX. PENAL CODE ANN. § 42.09, Desecration of Venerated Object (1989) provides:

victed and sentenced to one year in prison and fined U.S. $2000.00. The Court of Appeals for the Fifth District of Texas affirmed Johnson's conviction, but the Texas Court of Criminal Appeals reversed, holding that the State could not, consistent with the First Amendment, punish Johnson for burning the flag in those specific circumstances.

Johnson participated in a political demonstration held in Dallas in 1984, during the Republican National Convention, against the policies of the Reagan Administration. At the end of the demonstration, in front of the Dallas city hall, Johnson burned an American flag. He was convicted of desecrating a flag by burning it rather than for uttering insulting words. The U.S. Supreme Court held that Johnson's burning of the flag constituted expressive conduct, permitting him to invoke the First Amendment.[100]

The next question the Supreme Court had to answer was whether the State's regulation was related to the suppression of free expression.[101] The Court answered affirmatively, and then used a high standard of scrutiny to decide whether the State's interest justified Johnson's conviction.[102] The Court found that Johnson's burning of the flag was conduct "sufficiently imbued with elements of communication" to implicate the First Amendment.[103] Johnson's burning of the flag as part of the political demonstration that coincided with the convening of the Republican Party and its renomination of Ronald Reagan for President was held by the Court to be of an expressive, overtly political nature.[104] The Court stated that while the government may regulate such expressive conduct, the regulation must be for reasons separate from the content of such conduct.

(a) A person commits an offense if he intentionally or knowingly desecrates:

(1) a public monument;

(2) a place of worship or burial; or

(3) a state or national flag.

(b) For purposes of this section, 'desecrate' means deface, damage, or otherwise physically mistreat in a way that the actor knows will seriously offend one or more persons likely to observe or discover his action.

(c) An offense under this section is a Class A misdemeanor.

100. *Johnson*, 491 U.S. at 406.

101. *Id.* The Court, in United States v. O'Brien, 391 U.S. 367 (1968), held that if State regulation is not related to expression, then the less stringent standard for regulation of non-communicative conduct should be applied. In this case, the Court had to decide first whether draft card burning during the Vietnam War protests was protected as speech by the First Amendment. In *O'Brien*, the Court held that when speech and non-speech are combined in conduct, an incidental restriction of expression resulting from regulating the non-speech element could be justified only if the following conditions were satisfied: (1) the regulation furthered an important or substantial governmental interest; (2) the government interest was unrelated to the suppression of free expression; and (3) the incidental restriction on freedom was no greater than essential to the furtherance of that interest. *Id.*

102. *Johnson*, 491 U.S. at 412. The Court held that, although Johnson had raised a facial challenge to Texas' flag-desecration statute, it chose to resolve the case on the basis of Johnson's claim that the statute, as applied to him, violated the First Amendment. *Id.*

103. *Id.* at 406.

104. *Id.*

Here the State offered two rationales. First, the restriction was intended to prevent breaches of the peace. This rationale was held insufficient, for it did not automatically follow that conduct such as that in which Johnson engaged leads to breaches of the peace. In the case at hand, in the demonstration in question, no violence erupted.[105] Second, the regulation would preserve the flag as a symbol of nationhood and national unity. The Court held that the interest of the State in preserving the special symbolic character of the flag by restriction on Johnson's expression was content-based so that "the most exacting scrutiny" had to be applied.[106]

The Court then confirmed its principle view: "If there is a bedrock principle underlying the First Amendment, it is that the government may not prohibit the expression of an idea simply because society finds the idea itself offensive or disagreeable."[107] The Court did not recognize an exception to that principle, even where the American flag was involved.[108]

With reference to *Schacht*,[109] the Court emphasized that it had never held that the government may demand that a symbol be used to express only one view of that symbol or its referents.[110] In *Schacht v. United States*, the Court invalidated a federal statute permitting an actor portraying a member of one of the U.S. armed forces to "wear the uniform of that armed force if the portrayal does not tend to discredit that armed force." That proviso, the Court held, "which leaves Americans free to praise the war in Vietnam but can send persons like Schacht to prison for opposing it cannot survive in a country which has the First Amendment."[111]

Comparing the U.S. flag with the Presidential Seal or the Constitution, the Court held that there was no indication — either in the text of the Constitution or in opinions interpreting the Constitution — that a separate juridical category existed for the American flag alone.[112] The Court said it was not the state's ends but the means to which it objected. The Court recognized that the government had a legitimate interest in "preserv[ing] the national flag as an unalloyed symbol of our country,"

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105. *Id.*
106. *Id.*
107. *Id.*
108. *Id.*, *citing* Street v. New York, 394 U.S. 576 (1969). In *Street*, the Court held that a state may not criminally punish a person for uttering words critical of the flag. Rejecting the argument that the conviction "could be sustained on the ground that the accused had failed to show the respect for our national symbol which may properly be demanded of every citizen," the Court concluded that "the constitutionally guaranteed freedom to be intellectually . . . diverse, or even contrary, and the right to differ as to things that touch the heart of the existing order encompass the freedom to express publicly one's opinions about our flag, including those opinions which are defiant or contemptuous." *Id.*
109. 398 U.S. 58 (1970).
110. *Johnson*, 491 U.S. at 417.
111. *Id.*, *citing* Schacht v. United States, 398 U.S. 58 (1970).
112. *Id.*

but held that this interest did not justify criminal punishment of a person for burning a flag as a means of political protest.[113]

The Court viewed its decision in *Johnson* as a reaffirmation of the principles of freedom and inclusiveness that the flag best reflected, and of the conviction that the American people's tolerance of criticism such as Johnson's was a sign and source of its strength. The Court saw that it is the nation's resilience, not its rigidity, that is reflected in the flag, and it was that resilience that the Court wanted to reassert.[114]

In a dissenting opinion, Chief Justice Rehnquist held that the American flag enjoys a unique position as a national symbol, and from that it derived a special class of deserved protection.[115] Chief Justice Rehnquist considered Johnson to have been free to make any verbal denunciation of the flag that he wished, that Johnson had been free to burn the flag in private, or could have burned other symbols of the government.[116]

To penalize flag burning if the actor knows that it will seriously offend other persons who observe or discover his action[117] was viewed by the Chief Justice as justified because it deprived the actor of only one "rather inarticulate symbolic form of protest," and left him many other symbols and every form of verbal expression by which to express his disapproval of national policy.[118] Chief Justice Rehnquist held that Johnson was punished for his use of the flag, and not for the idea he sought to convey by burning it.[119]

C. *The Case of U.S. v. Eichmann*

In 1990, the U.S. Supreme Court had to decide again whether the protection of the American flag and its symbolic value entitles the legislature to limit the constitutional right of freedom of speech as granted by the First Amendment.[120]

While the Court in *Johnson*[121] held a provision of the Texas Penal Code to be incompatible with the Constitutionally granted right of freedom of speech, the Court had to review in *Eichmann* the question of whether a federal statute, the Flag Protection Act of 1989,[122] was consistent with the First Amendment.

Congress passed the Flag Protection Act of 1989 as a response to the

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113. *Id.*
114. *Id.*
115. *Id.*
116. *Id.* at 418.
117. TEX. PENAL CODE ANN. § 42.09 (1989).
118. *Johnson*, 491 U.S. at 432.
119. *Id.* Chief Justice Rehnquist viewed it as one of the high purposes of a democratic society to legislate against conduct that is regarded as evil and profoundly offensive to the majority of people - whether it be murder or flag-burning. *Id.* at 435.
120. U.S. v. Eichmann, 496 U.S. 310 (1990).
121. 491 U.S. 397 (1989).
122. 18 U.S.C. § 700 (Supp. 1990).

Court's opinion in *Texas v. Johnson*.[123] The Flag Protection Act of 1989 criminalized the conduct of anyone who "knowingly mutilates, defaces, physically defiles, burns, maintains on the floor or ground or tramples upon" a United States flag, except conduct related to the disposal of a "worn or soiled flag."

Based on the Flag Protection Act of 1989, several demonstrators who publicly burned the American flag to protest the politics of the Reagan administration or, in some cases, burned the flag to protest the Flag Protection Act of 1989, were indicted in several states. In every case, the U.S. District Courts dismissed the charges with respect to the decision of the Supreme Court in *Johnson*, and held the Flag Protection Act to be in violation of the First Amendment.

The appeals were consolidated and dismissed by a majority of five Justices. The U.S. Supreme Court confirmed its holding in *Johnson* and referred to that opinion.[124] The Court considered it important that the Flag Protection Act of 1989 was aimed at the limitation of freedom of speech by penalizing the desecration of the flag by burning it or by other means of physical mistreatment.[125]

Congress had chosen a neutral wording of the statute by penalizing every intentional desecration of the flag, while the Texas Penal Code[126] in *Johnson* penalized a person only for desecration of the flag if the actor knew it would seriously offend other persons.

However, the Court in *U.S. v. Eichmann*[127] held that, though the plain meaning of the Federal statute neither mentioned the actor's motives nor the effect of his act on third persons, the Flag Protection Act of 1989 was aimed at penalizing only such acts of flag desecration which were used by an actor to express publicly an opinion that was directed against the flag as a symbol of nationhood and national unity. Therefore, the Court continued, an indictment and conviction under the Flag Protection Act of 1989 constituted a direct violation of freedom of speech as granted by the First Amendment. When there is direct restriction of expression, the State's asserted interest in preserving the special symbolic character of the flag must be subjected to the most exacting scrutiny. The Court held that the First Amendment's freedom to express even opinions rejected by the majority of the people has preference over the State's in-

123. Immediately after the decision in the flag-burning case (*Texas v. Johnson*) was announced, President Bush responded to the decision by announcing that he would seek a Constitutional amendment to prohibit the burning of the American flag. He added, "Protection of the flag, a unique national symbol, will in no way limit the opportunity nor the breadth of protest available in the exercise of free speech rights." Bipartisan Congressional support greeted the proposal; public opinion polls indicated that the *Johnson* decision was very unpopular. RONALD D. ROTUNDA, MODERN CONSTITUTIONAL LAW: CASES AND NOTES 93 (3d ed. Supp. 1989).

124. *Eichmann*, 496 U.S. 310 (1990).

125. *Id.* at 314.

126. TEX. PENAL CODE ANN. § 42.09.

127. *Eichmann*, 496 U.S. at 314.

terest in protecting symbols as the State's media of identification and integration. Therefore, the Court held that the Flag Protection Act of 1989 violated the Constitutional right to freedom of speech, even though a majority of the people was in favor of penalizing flag burning.[128]

In his dissenting opinion, Justice Stevens objected, stating that the First Amendment does not grant absolute protection to any kind of expression. The Constitutional protection of freedom of speech does not immunize any attack on Constitutional values and symbols. The flag, as a national symbol, has to be protected from destruction and desecration, even though those acts are done to express a certain opinion.[129]

V. Similarities and Differences Between the German, European and United States Approaches

The German and the U.S. Constitutions both contain provisions that grant freedom of speech. While the plain meaning of the U.S. Constitution seems to grant unlimited freedom of speech, the Article of the German Constitution that grants freedom of speech[130] itself describes the borders of that freedom. However, artistic freedom, as provided in Article 5(III) of the German Constitution is not limited by the language of the Article granting freedom of speech.

In the U.S., the limits to freedom of speech are determined by the highest U.S. court, the Supreme Court; the highest German court, the Federal Constitutional Court,[131] also determines the extent of freedom of speech. The reasoning of the German Federal Constitutional Court's decision of March 7, 1990, is close to the reasoning of the dissenting opinions in *Texas v. Johnson*[132] and *U.S. v. Eichmann.*[133]

The European Court of Human Rights, in the case of Mueller, had to interpret the freedom of speech as granted in the Convention. This Article bestows freedom of speech within the limits of the "duties and responsibilities it carries with it,"[134] so that by its plain meaning there is a limitation. The duties and responsibilities have to be determined by each Contracting State to the European Convention on Human Rights. There is wide room for discretion on the part of national authorities of the Contracting States in limiting the freedom of speech as granted by the Convention by means of national penal statute.

VI. Conclusion

Freedom of speech as granted in the European Convention on

128. *Id.* at 315.
129. *Id.* at 316.
130. GG art. 5.
131. Bundesverfassungsgericht.
132. 491 U.S. 397 (1989).
133. 496 U.S. 310 (1990).
134. MRK art. 10(II).

Human Rights and as interpreted by the European Court of Human Rights has the lowest level of protection in comparison to Germany and the United States of America. Although several of the Contracting States to the European Convention on Human Rights are not currently members of the European Community, they are all prospective members. The European Convention on Human Rights may one day become part of a constitution of the European Community. Under that scenario the provisions protecting freedom of speech should, in order to offer the most effective protection, be revised and approximated to the provisions in the German or U.S. constitutions.

The decision process and the results of the U.S. Supreme Court's decisions in the area of freedom of speech seem to be more liberal than the practice of the German Federal Constitutional Court. The decisions of the U.S. Supreme Court tend to come closer to the real meaning of freedom of speech as granted by the Constitutions of both States.

Comprehensive education and training of German Federal Constitutional Court judges in comparative law may have prevented the German Court from holding, in the case decided on March 7, 1990, that freedom of speech as granted by the German Constitution in GG Article 5(III) does not generally preclude punishment under the German Penal Code.

The German courts are upholding their rather restrictive view. In October, 1991, the Court of First Instance[135] in Munich fined Volker A. Zahn, author of an article published in the German news magazine *Wiener*, and Wolfgang Maier, its publisher, DM 2000 and DM 7000 respectively for publishing an article in the magazine. The four page long article's headline was "Bavaria: The Madhouse of the Republic" (*Bayern: Das Irrenhaus der Republik*), and its subheadline was "My Ass is Licked" (*Mi leckst am Oarsch*).

The journalist and publisher were prosecuted for, and convicted of, a violation of Section 90(a)(I)(1) of the German Penal Code for insulting, and maliciously scorning the Federal State of Bavaria by means of the article.[136] Judge Dieter Schoepf held that the publisher and author desecrated the State of Bavaria by calling it "the madhouse of the Republic" and by equating it with the former State of East Germany.[137]

It will be of great interest to review the outcome of appeals to this decision if they reach the German Federal Constitutional Court, or even the European Court of Human Rights.

Bernhard Jürgen Bleise

135. Amtsgericht Muenchen.
136. *Compare* Chapter III(B)(6) regarding StGB § 90(a).
137. DER SPIEGEL, Oct. 28, 1991, at 348.

TABLE OF ABBREVIATIONS

BayVB1	Bayerisches Verwaltungsblatt
BSGE	Entscheidungen des Bundessozialgerichts Decisions of the German Federal Social Law Court
BVerfG	Bundesverfassungsgericht German Federal Constitutional Court
BVerfGE	Entscheidungen des Bundesverfassungsgerichts Decisions of the German Federal Constitutional Court
EGMR	Europaeischer Gerichtshof fuer Menschenrechte European Court of Human Rights
EuGRZ	Europaeische Grundrechte
GG	Grundgesetz Basic Law of The Federal Republic of Germany
J.Z.	Juristenzeitung
MDR	Monatszeitschrift fuer deutsches Recht
MRK	Konvention zum Schutze der Menschenrechte und Grundfreiheiten European Convention on Human Rights
N.J.W.	Neue Juristische Wochenschrift
NStZ	Neue Zeitschrift fuer Strafrecht
OLG	Oberlandesgericht Court of Appeals
OVG	Oberverwaltungsgericht Superior Administrative Court
RGBl	Reichsgesetzblatt Law Gazette of the German Reich (until 1945)
RGSt	Reichsgericht-Rechtsprechung in Strafsachen Decisions of the Supreme Court of the German Reich in penal cases (until 1945)
Schweiz StGB	Schweizerisches Strafgesetzbuch Swiss Penal Code
StGB	Strafgesetzbuch German Penal Code
ZBl	Schweizerisches Zentralblatt fuer Staats-und Gemeindeverwaltung

The Anti-Competitive Effect of the Internal Revenue Code on United States-Based Multinational Corporations

I. Introduction

Events of the past few years serve as pertinent reminders that the world situation is constantly evolving. These events not only are reforming and redrawing political lines, but are expanding the global marketplace. The creation of the European Community ("EC") has forced the United States to scramble to achieve a similar structure in North America. The reunification of Germany and the fall of communism in general have opened up fledgling markets in Eastern Europe which are already being targeted by multinational corporations ("MNCs") as the next "new" business frontier.[1]

The magnitude and rapidity of these events leave no uncertain question that a strong U.S. presence in the global economy is necessary in order for the country to remain an economic power. U.S. tax policy, however, has failed to keep pace with these changes in the world marketplace. Restrictive tax policies are make it increasingly difficult and costly for U.S.-based MNCs to compete effectively against their major competitors. A failure to correct basic deficiencies in U.S. tax polices will cause the U.S. to fall behind other world economic powers in competing for a larger share of a growing market.[2]

This paper is an attempt to show how provisions in the Internal Revenue Code impose on U.S. MNCs costly choices and disadvantages which are not faced by other competitors in the international marketplace. Initially, this paper examines the globalization of the world marketplace. Next, it provides a brief introduction to international tax concepts which are essential to a U.S. MNC's ability to compete. The paper then analyzes certain provisions of the Internal Revenue Code (I.R.C.), discussing their anti-competitive effects and the simple solutions which would eliminate those effects. Finally, it concludes that Congress and the I.R.S. must enact solutions to these problems immediately in order to maintain the international competitive position of U.S. MNCs.

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1. *See, e.g.*, Alan Friedman, *Coke Leaves No Height Unscaled: Reigning Cola King's Global Sales Assault Aims to Conquer Even Mount Everest*, FIN. POST, Jan. 17, 1992, at 39.
2. *See* PRICE WATERHOUSE, U.S. INTERNATIONAL TAX POLICY FOR A GLOBAL ECONOMY 25 (1991).

II. THE GLOBAL ECONOMY

In recent years, the removal of cross-border investment controls and foreign exchange controls have provided an environment for increased activity by MNCs.[3] The removal of many non-tax barriers to trade and investment has increased global competition and correspondingly has made differences in the way countries tax corporate profits (one of the few remaining barriers to the efficient allocation of capital).[4]

The competitive problem of the U.S. must be viewed in this context. As tax considerations become more of a burden on U.S. MNCs, but not on their competitors, U.S. businesses will be unable to participate in many of these new markets.[5] Accordingly, the economic problems faced by this country will be exacerbated as its corporations are denied effective access to major new sources of income.

The U.S. is no longer the only dominant player in global markets. In 1960, of the top twenty industrial corporations as measured by sales, eighteen were located in the U.S.[6] These twenty corporations also accounted for over eighty-seven percent of worldwide sales.[7] In 1988, the number of such corporations located in the U.S. was halved.[8] Additionally, the overall market share of these twenty corporations had decreased to fifty-four percent.[9] During this same time period, the Pacific Rim and Western Europe emerged as sleeping giants poised to strip the U.S. of much of its international economic influence.

The markets in which these players compete are also undergoing fundamental changes. In 1987, the EC adopted the Single European Act, which committed the EC to creating a single market beginning in 1992.[10] In 1988, Canada and this government signed the U.S.-Canada Free Trade Agreement.[11] Currently, negotiations are underway with Mexico to create eventually a North American Free Trade Zone.[12] With the former Eastern European countries now asking for membership in the EC, it is not too difficult to envision free trade zones existing soon throughout North America and most of Europe.

The prospect of U.S. companies losing their competitive edge as world markets expand becomes even more alarming in light of the U.S. economy's increasing reliance on foreign income. The value of interna-

3. *Factors Affecting International Competitiveness: Hearings Before the House Comm. on Ways and Means*, 102d Cong., 1st Sess. (1991) (statement of John G. Wilkins, Director of Tax Policy for Coopers & Lybrand).
4. *Id.*
5. *Id.*
6. PRICE WATERHOUSE, *supra* note 2, at 57.
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.* at 61.
11. *Id.*
12. *Id.*

tional trade as a percentage of corporate net income has doubled, and the foreign affiliates' share of total U.S. corporate earnings has tripled over the last forty years.[13]

It is therefore clear that the globalization of the world economy and the lifting of restrictions to enter these marketplaces will cause U.S. tax policy to have a direct effect on the ability of the U.S. MNCs to compete against foreign competitors who are not burdened by their home government's foreign income tax system.

III. THE U.S. FOREIGN INCOME TAX SYSTEM

The present tax system evolved from a set of provisions intended to encourage and accommodate international operations by U.S. corporations.[14] Behind these provisions lay the fundamental concepts of relief from double taxation and tax deferral.[15] The effective operation of these concepts is the key factor in a U.S. MNC's ability to compete in foreign markets. Should a provision fail to advance one of these intentions, as is the case with many current provisions, a company's competitive ability will be correspondingly impaired.[16]

Because the U.S. taxes income on a worldwide basis,[17] double taxation of foreign income prevails.[18] Without relief from this burden, investment in a foreign country can become so unprofitable that an MNC may be forced to withdraw its operations abroad solely for tax and not business considerations.[19] Thus, the government provides relief from double taxation through use of the foreign tax credit.[20] This practice allows income taxes paid to another country to serve as a credit against current U.S. taxes.

However, defects with the foreign tax credit system, such as the in-

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13. PRICE WATERHOUSE, *supra* note 2, at E-3. Specifically, the foreign income share of worldwide profits as a percentage of GNP has risen from 5.1% in the 1950's to 15.4% in the 1980's. *Id.* at 34.

14. *See* RICHARD L. DOERNBERG, INTERNATIONAL TAXATION 3 (1989).

15. *See* JOSEPH ISENBERGH, 1 INTERNATIONAL TAXATION 18-20 (1990) [hereinafter ISENBERGH I].

16. *See id.*

17. *See* I.R.C. § T 61(a) (providing that "gross income means all income from whatever source derived").

18. Double taxation occurs when two countries simultaneously have and exercise taxing jurisdiction with respect to the income of a taxpayer. *See* DOERNBERG, *supra* note 14, at 6-7. A nation's tax jurisdiction may be based on one of two principles: territorial or personal. As all countries generally will tax income which is earned by a foreigner within their territorial boundaries, the U.S. taxation of worldwide income will necessarily create double taxation. *See id.* at 102.

19. *Factors Affecting International Competitiveness: Hearings Before the House Comm. on Ways and Means*, 102d Cong., 1st Sess. (1991) (statement of Alan J. Lipner, Tax Council on Tax Policy and International Competitiveness) [hereinafter Tax Council].

20. The foreign tax credit, first enacted in 1918, is set forth in I.R.C. §§ 901-908. For an extended discussion of the mechanics of the credit see ISENBERGH I, *supra* note 15, at 472-81.

come sourcing rules, prevent the system from providing relief. For example, when faults with credit computation prevent an MNC from offsetting its U.S. liability with taxes paid to France, the MNC will be double taxed and thus will face a disadvantage with other foreign competitors who are effectively assessed only by the French.

The sourcing rules of the I.R.C.[21] therefore are arguably some of the most important provisions affecting foreign income taxation. These rules identify items of income and expense as derived from either domestic or foreign sources. The distinction between sources of income is crucial, as the U.S. will defer to the taxing jurisdiction of a foreign government and provide relief from double payments only for income recognized as foreign sourced.[22] The sourcing rules directly determine not only whether relief will be available but also the amount of that relief, because the foreign tax credit is limited in proportion to the amount of foreign sourced net income.[23]

The second major policy which enables U.S. MNCs to compete abroad is tax deferral. Deferral refers to the general rule that income earned through a foreign subsidiary will not be subject to U.S. taxation until that income is repatriated here in the form of dividends, royalties, or interest.[24] Deferral therefore results in the postponement of U.S. taxes.

Deferral of income is extremely important to most MNCs, since it is one of the primary mechanisms which put U.S. corporations on an equal footing with competitors from other nations who do not tax foreign earnings at all or who maintain strict deferral regimes.[25] Deferral enables a U.S. corporation to compete by providing the opportunity to reinvest 100% of a subsidiary's earnings in current and/or expansion operations. For many MNCs which cannot make continuous capital contributions to a subsidiary, the ability to utilize untaxed unrepatriated earnings is the only economical way operations can be conducted in foreign markets.[26]

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21. The sourcing rules are set forth in I.R.C. §§ 861-865. *See generally* DOERNBERG, *supra* note 14, at 29-55.

22. *See* ISENBERGH I, *supra* note 15, at 18.

23. An overly simplified foreign tax credit limitation would be computed as follows: Foreign taxes paid times (foreign sourced income/world wide income). I.R.C. § T 904(a). Thus, as the numerator is adjusted upward for an allocation of income, a greater credit against taxes will be allowed. Conversely, allocations of expenses decrease the numerator and the limitation amount.

24. *See* ISENBERGH I, *supra* note 15, at 20.

25. *See* ROBERT A. RAGLAND, TAXATION OF FOREIGN SOURCE INCOME 19-20 (1990); *Factors Affecting International Competitiveness: Hearings Before the House Comm. on Ways and Means*, 102d Cong., 1st Sess. (1991) (statement of Allen C. Holmes, American Petroleum Institute) [hereinafter API Statement].

26. Letter from Louis J. Williams, Vice President EG&G, to Kenneth H. Gideon, Assistant Secretary Department of the Treasury (Feb. 27, 1990), available on LEXIS, Tax Notes Int'l, File No. 90 TNI 21-39; *see also Factors Affecting International Competitiveness: Hearings Before the House Comm. on Ways and Means*, 102d Cong., 1st Sess. (1991) (statement of Philip J. Loree, Chairman of the Federation of American Controlled Shipping) [hereinafter FACS Statement].

Because many corporations have used deferral for tax avoidance purposes, and because its advantages may serve as an incentive to shift investment abroad from the U.S., Congress began in 1962 to enact a variety of rules which subjected non-repatriated subsidiary earnings to current U.S. taxation, thereby accelerating the recognition of income to shareholders in foreign corporations and eliminating the benefits of deferral.[27] In general, these rules were needed in order to prevent the loss of governmental revenue caused by corporations operating in tax havens.[28] However, a variety of defects in these provisions have caused a loss of deferral for legitimate foreign operations.

As the availability of deferral is eroded and foreign operations are currently taxed, a U.S. MNC will be at a competitive disadvantage with a similarly situated competitor from another country who benefits from the current use of 100% of its earnings abroad.[29]

IV. THE ANTI-COMPETITIVE EFFECT OF THE INTERNAL REVENUE CODE ON U.S.-BASED MNCS

The I.R.C. presently contains many provisions which fail either in part or whole to advance the policies of double taxation relief and deferral.[30] As a result of these deficiencies, U.S. MNCs are forced to shoulder a greater tax burden than their rivals, a burden which in turn impairs their competitive ability. The following representative provisions illustrate how simple defects in the code can lead to the erosion of a competitive position in the global marketplace.

A. *The Allocation of Interest Expense and the Denial of Double Taxation Relief*

As mentioned above, the sourcing rules require the allocation of expenses to income characterized as foreign sourced. When expenses are increasingly allocated to this income, the foreign tax credit limitation, and thus the amount of relief from double taxation, correspondingly decreases.[31] So long as the costs so identified are actually recognized by a foreign country in their determination of a U.S. MNC subsidiary's taxable income, double taxation relief is not affected.

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27. *See generally* JOSEPH ISENBERGH, 2 INTERNATIONAL TAXATION 15, 19-21 (1990) [hereinafter ISENBERGH II].

28. *See id.* at 2.

29. FACS Statement, *supra* note 26. If a U.S. MNC is currently taxed on unrepatriated earnings, it will be at a disadvantage as it must compete with only sixty-six percent of its subsidiary's earnings (100% minus 34% U.S. corporate tax rate) against competitors that have available 100% of their subsidiary's earnings for operations and expansion. *Id.*

30. Examples of such provisions include I.R.C. § A4 6411(a) foreign tax credit carryover rules; I.R.C. § A4 904(e) alternative minimum tax foreign tax credit; I.R.C. § T 263A uniform capitalization rules applicable to foreign persons; I.R.C. § T 904(d)(3)(e) foreign corporation look through rules; I.R.C. § T 861 expense allocation rules; I.R.C. § T 989 exchange rates for foreign taxes.

31. *Supra* note 23.

The IRC, however, provides for the significant allocation of many costs to foreign income in such arbitrary ways that an MNC is denied a tax benefit for the expenditures allocated. Of these items, interest provides an appropriate example, as it is one of the largest expenses incurred by virtually all corporations.[32]

Prior to the Tax Reform Act of 1986 (TRA '86), allocation of interest did not cause problems for U.S. MNCs, since the optional gross income method allowed a corporation to determine interest expense on a company-by-company basis.[33] If a subsidiary had interest cost but no foreign assets, one hundred percent of the interest was allocated to U.S. income and the foreign tax credit limitation was not adversely affected.

However, TRA '86 changed the regulations and required that where there is a group of companies eligible to file a consolidated U.S. tax return, interest expense should be spread among the assets of the affiliated group[34] and not on a separate company-by-company basis as previously provided.[35] The effect of this change was to make allocation of such costs to foreign-source income unavoidable.

Thus, under the current fungibility method,[36] a required dispersal of interest expense likely will result in an allocation of expenditures not recognized by a foreign country in their own determination of a U.S. MNC's tax liability. Those corporations therefore will effectively be denied a deduction for such expense in both countries.[37]

To illustrate the problem, consider the following example:[38] A group

32. Tax Division of the American Institute of Certified Public Accountants, Comments on Proposed Regulations Under Section 861 and 864 Regarding the Allocation of Interest Expense 3 (1991)[hereinafter AICPA].

33. *See* Prior Treas. Reg. T 1.861-8(e)(2)(vi).

34. I.R.C. § T 864(e)(5)(A). An affiliated group of companies is a chain of companies connected to a common parent by stock ownership of at least eighty percent. I.R.C. § A4 1504(a). The effect of treating a group of companies as affiliated is to treat the group as if it were one corporation. Temp. Treas. Reg. T 1.861-9T(a).

35. *See* I.R.C. § T 864(e). U.S. taxpayers must now allocate interest expense to foreign and domestic sourced income based on the relative gross value of consolidated foreign and domestic assets. Temp. Treas. Reg. T 1.861-9T(g) The principle of fungibility governs this required method of allocation. Treas. Reg. T 1.861-8T(a) The principle reflects the view that money is fungible and that there is flexibility in both obtaining and utilizing those funds. *Id.* It suggests that when money is borrowed for a specific purpose, those borrowings free up funds for use elsewhere. Thus, it is reasoned that borrowings even for a specific purpose should be allocated among all of the assets of the borrower. *See* ISENBERGH I, *supra* note 15, at 205-206 (1990).

36. *Supra* note 35.

37. The effective non-deductibility of expenses is caused by a reduction in the allowable foreign tax credit limitation. The decrease in the foreign tax credit results in the inability of a corporation to claim a credit for all foreign taxes incurred. This causes U.S. tax liability to increase in the same way as if deductibility was denied for the interest expense allocated. PRICE WATERHOUSE, *supra* note 2, at 79.

38. Example modified from *Factors Affecting International Competitiveness: Hearings Before the House Comm. on Ways and Means*, 102d Cong., 1st Sess. (1991) (statement of Jere D. McGaffey, Chair ABA Section of Taxation) [hereinafter ABA Statement].

of U.S. investors decide to manufacture bicycles both here and in a foreign country. The U.S. parent is incorporated, with assets of $10 million and the subsidiary with assets of $5 million. The two corporations separately borrow $500,000 at ten percent, secured by their respective assets. Yet the interest expense is now allocated pro-rata based on relative gross assets. Of the $50,000 interest incurred in the U.S., $16,667 is assigned to foreign source income. Yet none of the corresponding expenses of the foreign subsidiary is assigned to U.S. source income because the fungibility of interest does not extend to interest incurred by foreign subsidiaries.[39] Of the $100,000 of interest expense incurred equally here and abroad, $66,667 is allocated to foreign source income while only $33,333 is allocated to U.S. income.

The foregoing system results in an understatement of foreign income and an overstatement of U.S. income which, once placed into the foreign tax credit limitation calculation, creates an effective denial in this example of $16,667 of interest expense. This regulation constitutes a competitive disadvantage because an MNC is denied a tax benefit normally accorded to any other entity incurring such an expense.[40] The magnitude of the disadvantage caused by present law becomes clear when it is understood that a U.S. MNC effectively loses a deduction for all interest allocated to foreign source income. This requirement translates into a situation in which a U.S. MNC cannot avoid paying additional current taxes in an amount equal to thirty-four percent[41] times any interest expenses so assigned. The additional tax has been estimated to increase the effective rate of U.S. taxation on its MNCs by six to eleven percentage points.[42]

It is important to note that such an allocation will be required even when the fungibility principle has been complied with. The premise of fungibility insists that interest expense should be allocated among those assets which may conceivably support the borrowing. However, where a subsidiary of a U.S. MNC finances its activities by securing its own assets, without any guarantees or assistance from other members of the affiliated group, affiliation of the associated interest expense to other members of the group is still required.[43] Requiring allocation under these circumstances stands in direct conflict with this basic principle.

A U.S. MNC thus faces a disadvantage with each of its competitors. A purely domestic rival will be able to deduct the entire $50,000 of inter-

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39. Temp. Treas. Reg. T 1.861-9T(a) sets forth the fungibility principle as it applies to U.S. corporations. *See* Temp. Treas. Reg. T 1.861-9T(a). Foreign corporations' recognition of interest expense is covered by Reg. T 1.882-5 where the fungibility principle is not recognized. See Treas. Reg. T 1.882-5; Temp. Treas. Reg. T 1.861-9T(a). The non-fungibility of interest incurred by a U.S. owned foreign subsidiary has been severely criticized. *E.g.*, AICPA *supra* note 32, at 1.

40. I.R.C. § T 163(a).

41. Currently the highest corporate tax rate. I.R.C. § T 11.

42. PRICE WATERHOUSE, *supra* note 2, at 79 (increase based on case study examples).

43. *See* Temp. Treas. Reg. 1.861-11T(c).

est and therefore will pay less tax.[44] Similarly, the U.S. subsidiary of a foreign-based MNC can deduct the $50,000 of interest related to its activities here.[45] This is true even though that corporation may have both foreign and U.S. assets, since the fungibility principle does not extend to subsidiaries of foreign MNCs.[46] Because a U.S. MNC cannot deduct 100% of its interest, the allocation rules ironically make the after-tax cost of facilities built in the U.S. with borrowed funds more expensive for a U.S. MNC than for a foreign one.[47]

Further, MNCs based in all six of the other major industrialized nations[48] can benefit fully from interest expense generated by borrowings on the part of their home-country parent or its subsidiaries.[49] As a result, U.S. MNCs must pay additional taxes which are not incurred by their foreign competitors. These excess costs impair a U.S. company's ability to compete on equal footing internationally.

The provisions diminish the U.S. corporation's ability to compete at home as well as in foreign markets. This effect arises not only from the increased direct tax costs previously identified, but also from the adverse effect such additional taxes have on management decision making. In projecting a rate of return, a U.S. MNC wishing to expand U.S. facilities by incurring debt faces a rate of return approximately one to three percent lower[50] than a domestic or foreign competitor. A U.S. MNC is therefore left with a choice, not imposed on its rivals, of commencing a project which will yield an uncompetitive rate of return, or funding the project with equity funds at the expense of its owner's financial objectives[51] and its marketing position.[52]

The basic solution to the problems caused by IRC § 864 is to apply the principle of fungibility uniformly to both U.S. MNCs and their for-

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44. I.R.C. § T 163(a).

45. *Id.*

46. Temp. Treas. Reg. T 1.861-9T(a) (regulation applicable only to U.S. based groups).

47. This is a major competitive disadvantage which is viewed with disdain by most commentators. *See, e.g.*, AMERICAN BAR ASSOCIATION SECTION OF TAXATION, COMMENTS ON THE IMPAIRMENT OF THE ABILITY OF U.S.-BASED MULTINATIONAL COMPANIES TO COMPETE IN THE UNITED STATES RESULTING FROM THE INTEREST-EXPENSE ALLOCATION PROVISIONS 7 (1991) [hereinafter INTEREST COMMENTS].

48. The United Kingdom, France, Germany, the Netherlands, Japan, and Canada.

49. PRICE WATERHOUSE, *supra* note 2, at 79-80.

50. *See* INTEREST COMMENTS, *supra* note 47, at 3-6 (lower rate of return is a result of lower projected net earnings due to higher tax costs).

51. Most corporate shareholders prefer debt over equity financing. Among other reasons, owners will have less investment at risk and the subsequent leveraging increases the rate of return on the existing equity investment. *See* ROBERT W. HAMILTON, CORPORATIONS 322-4 (4th ed., 1990).

52. U.S. MNCs are at a disadvantage when they are not free to do exactly as their competitors do. Therefore, when a domestic or foreign owned competitor finances activities with debt, a U.S. MNC facing a loss of deductions associated with that debt is not similarly situated. INTEREST COMMENTS, *supra* note 47, at 6-7.

eign-based competitors.[53]

In a situation where the borrowings of the parent or a U.S. subsidiary are secured by their own assets, without any guarantees by other group members, the interest expense deriving from that debt should be allocated in full to U.S. source income of the borrower and excluded from the allocation process.[54] This adjustment would be in complete compliance with the fungibility principle, with interest assigned to the assets which ultimately support the borrowing. Such a change would result in full deductibility of the interest expense and allow an MNC to compete on equal ground with a purely domestic corporation because all parties will be given the same U.S. tax treatment.

The fungibility principle must also be extended to the borrowings of foreign subsidiaries of U.S. MNCs. When any such subsidiary's loans are not secured by its own assets and assistance has been provided by a U.S. parent or subsidiary, there is no reason for treating the interest expense as non-fungible and unallocable to U.S. source income.[55] Indeed, if the principle of fungibility is to be correctly observed, the interest expense must be dispersed among all assets of the group which support the borrowing. This change will decrease the incidence of double taxation since the assignment of interest expense to U.S. income will correspondingly increase the foreign tax credit limitation and decrease the possibility of an effective denial of interest expense deductions. With such a correction, a U.S. MNC will realize a tax benefit for a majority of its interest expense, pay lower taxes, and thereby stand in a better competitive position. Fungibility of interest must also be extended to U.S. subsidiaries of foreign-based MNCs.[56] As previously discussed, these MNCs are treated in a completely different manner than their U.S. counterparts. In order to correct that disparate treatment and bring taxation of both U.S. and foreign entities into line with the treatment of U.S. MNCs, interest expense associated with borrowings not secured solely by a subsidiary's U.S. assets should be allocated away from U.S. income and a deduction denied for that amount of interest unconnected with U.S. assets. Such a correction is needed because the I.R.C. directly confers a competitive advantage on foreign-based MNCs at the expense of domestic competitors.

B. *Deferral of Income*

The anti-deferral regimes of the I.R.C. also suffer from defects which erode a U.S. MNCs ability to compete. The disadvantages imposed, however, are more severe than the denial of deductions and double tax relief. In most cases, the loss of deferral will have far-reaching effects on an

53. This position is advanced by virtually all commentators. *E.g.*, INTEREST COMMENTS, *supra* note 47, at 6-7; Tax Council, *supra* note 19.

54. *See* INTEREST COMMENTS, *supra* note 47, at 6.

55. Tax Council, *supra* note 19; PRICE WATERHOUSE, *supra* note 2, at 117.

56. INTEREST COMMENTS, *supra* note 47, at 7; Tax Council, *supra* note 19.

MNC, including not only the imposition of current taxes on income which is not yet in hand, but also the placement of burdens on such fundamental decisions as how and where to conduct foreign business.

Most tax authorities agree that the premise behind the enactment of the various anti-deferral regimes is legitimate.[57] The regulations were intended to impose current taxes on U.S. taxpayers who conduct business abroad primarily to escape U.S. taxation.[58] The provisions denying deferral therefore should extend their penalizing reach only to those corporations which are engaged in tax avoidance practices.[59]

In practice, however, legitimate overseas businesses are subjected to a loss of deferral because of outdated and conflicting provisions. Of all the anti-deferral regimes,[60] the Subpart F rules[61] for Controlled Foreign Corporations (CFCs) and the Passive Foreign Investment Company ("PFIC") rules[62] are most important, because their current defects pose the greatest problems for the competitive position of U.S. MNCs.

1. Subpart F and the European Community

Beginning in 1992, the European Community (EC) will begin to implement a plan designed to create a single market wielding $4 trillion of economic power and a population base of 323 million people from twelve countries.[63] Because of the removal of physical, tax and trade barriers, it is widely anticipated that EC-based companies will reorganize their current corporate structures within the new market in order to produce more efficient operations which are no longer constrained by geographic considerations.[64]

The EC Commission believes that the centralization of operations by European companies will produce savings of between $99-122 billion, primarily from more efficient procedures.[65] This reduction in operating costs will increase competition in the EC by enabling producers to lower prices. Those businesses that are unable to reduce their prices as a result of inefficient corporate structures will therefore be at a serious competitive

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57. *See, e.g.*, ISENBERGH I, *supra* note 15, at 20.

58. *See generally* ISENBERGH II, *supra* note 27, at 16, and 19-22.

59. *See* ISENBERGH I, *supra* note 15, at 19-20.

60. There are five regimes in total: Foreign Personal Holding Companies; Subpart F; Passive Foreign Investment Companies; Foreign Investment Companies; and Foreign Sales Companies. *See generally* ISENBERGH II, *supra* note 27, at 1, 21, 124, 130, and 231.

61. The Subpart F rules are set forth in I.R.C. §§ 952-964.

62. The PFIC provisions are set forth in I.R.C. §§ 1291-1297.

63. CLIFFORD CHANCE, THE CCH GUIDE TO 1993 CHANGES IN EEC LAW 1 (1989).

64. *See id.* at 78; and THE INTERNATIONAL COMPETITIVENESS IMPACT OF THE U.S. TAX LAW ON U.S.-BASED MULTINATIONAL COMPANIES WITH RESPECT TO THE EUROPEAN COMMUNITY 1992 PROPOSALS 1 (1991) [hereinafter EC Comments]. Regarding the removal of barriers, *see generally* CHANCE, *supra* note 63, at 2-11.

65. *Id.* at 16. The reduction of costs is one of the three principal reasons for achieving a single market. *Id.* at 13.

disadvantage.[66]

The stake of U.S. MNCs in the European market is high. Sales of durable goods alone to EC countries in 1988 amounted to nearly $40 billion.[67] Until now there were not significant differences in the operating structures of U.S.-based and EC-based competitors; member nations' regulations generally required a different company to sell goods in each of the twelve different countries.[68] The EC proposals, however, have fundamentally changed this picture so that in the future both U.S. and EC competitors may obtain the benefits of efficiency by centralizing their operations.

Significant opportunities therefore exist for U.S. MNCs in Europe, provided that they are not inhibited or prevented from achieving the same efficiencies as their EC counterparts. Unfortunately, U.S. tax law creates severe impediments to the realization of such efficiencies. The Subpart F provisions in particular force an American MNC to choose between consolidating European operations at the risk of losing tax deferral and suffering current taxation on a subsidiary's income, or else maintaining separate subsidiaries in each EC member country in order to avoid Subpart F taxes while suffering the competitive disadvantages caused by this kind of inefficiency.[69]

The Subpart F rules require U.S. shareholders of a CFC[70] to include in current gross income their pro-rata share of Subpart F income.[71] The largest category of Subpart F income, Foreign Base Company Income,[72] is divided further into subcategories of which Foreign Base Company Sales Income (FBCSI) is the most prevalent and important.[73] FBCSI income has three characteristics: (1) a product was bought by a CFC from a related party; (2) the product was manufactured or produced in a country other than the CFC's nation of incorporation; and (3) the product was resold by the CFC for use or consumption outside the CFC's place of incorporation.[74] In other words, when a CFC purchases goods from a U.S. parent or subsidiary and subsequently resells these goods to consumers in

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66. *See* John J. Salmon & Fred R. Gander, *Refining Subpart F to Make U.S. Firms More Competitive After 1992*, TAX NOTES INT'L, Jan. 1, 1990, at 99; CHANCE, *supra* note 63, at 15, 78.

67. Salmon & Gander, *supra* note 66, at 99 (*citing* INTERNATIONAL DIVISION U.S. CHAMBER OF COMMERCE, EUROPE 1992: A PRACTICAL GUIDE FOR AMERICAN BUSINESS 36-7 (1989)).

68. *See id.* at 98.

69. *See* EC Comments, *supra* note 64, at 3; Salmon & Gander, *supra* note 66, at 98.

70. A foreign corporation is a CFC if U.S. shareholders own more than fifty percent of the total combined voting power of its stock or more than half of the stock's total value. I.R.C. § 957(a). A U.S. shareholder is a U.S. "person" who owns ten percent or more of the total combined voting power of all classes of stock of such foreign corporation. I.R.C. § 951(b). A wholly owned foreign subsidiary of a U.S. MNC is a typical example of a CFC.

71. I.R.C. § 951(a).

72. Ernest Larkins, *Commerce Through a Foreign Subsidiary*, 9 INT'L TAX & BUSINESS LAW. 69 (1991).

73. ISENBERGH II, *supra* note 27, at 78; DOERNBERG, *supra* note 14, at 175.

74. I.R.C. § 951(a).

other countries, Subpart F FBCSI income will arise.

Consider our bicycle manufacturer again. Assume that in order to increase brand-name recognition and acceptance in Europe, the parent establishes a sales subsidiary in Germany. Further, not all earnings are repatriated but instead are reinvested in the CFC in order to expand operations. Income from sales within Germany would not come under Subpart F regulation as that money does not fall within the definition of FBCSI.[75] Sales from Germany to France, however, would qualify as Subpart F income and potentially be subject to current taxation. Significantly, if all the EC member nations were considered as one country for purposes of Subpart F, there would be no tax problem.

Because of the potentially harsh consequences of Subpart F taxation,[76] Congress has always provided an exception to non-CFC country sales. Prior to TRA '86, this exception was subjective and was based on a facts-and-circumstances test.[77] If a U.S. MNC could establish that the rerouting of sales was not for purposes of tax avoidance, then any income received by the CFC from consumers in non-CFC countries would remain untaxed until repatriated.

TRA '86 changed this policy to an objective test. Known as the "high tax" exception, income from non-CFC country sales now will not be taxed as FBCSI only so long as that income has been subjected to an effective rate of foreign tax greater than ninety percent of the maximum U.S. corporate rate.[78] Since all EC member nations have statutory tax rates greater than or equal to the domestic rate,[79] one would expect that a U.S. MNC could centralize its operations in one EC country and sell goods to the other eleven members without fear of Subpart F taxation. The reality of the situation, however, is the opposite because of uncertainties regarding the application of the high tax exception.

Consider the following example.[80] Our bicycle sales subsidiary earns French net income of one million dollars each year for three years and

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75. *See id.* and accompanying text. The exclusion of income generated by CFC country sales results from the "foreign country" exception. *See infra* note 87 and accompanying text.

76. When Subpart F is triggered, a taxpayer loses the benefit of deferral because taxes are imposed currently on income which has not been repatriated. A U.S. MNC therefore will have to compete against a foreign competitor with only 66% of its subsidiary's earnings rather than 100%. *See supra* note 29 and accompanying text.

77. Under prior I.R.C. § 954 (b), income would not be classified as FBCSI if a taxpayer could establish that neither (1) the creation of the foreign corporation nor (2) the transaction giving rise to the income had tax avoidance as one of its significant purposes. Prior I.R.C. § 954(b).

78. I.R.C. § 954(b).

79. Belgium 39%; Denmark 40%; France 34%; Germany 50%; Greece 46%; Ireland 40%; Italy 36%; Luxembourg 33%; the Netherlands 35%; Portugal 36%; Spain 35%; the United Kingdom 35%. ERNST & YOUNG INTERNATIONAL, WORLDWIDE CORPORATE TAX GUIDE (1991).

80. Example modification based on EC Comments, *supra* note 64, at 4.

pays French taxes at the thirty-four percent statutory rate. Because the rate abroad is greater than ninety percent of the rate here, income from French sales is not currently taxed by the U.S.

Assume that in year four there is a three million dollar loss, which when carried back results in a refund of the taxes paid to France in years one through three. As the income in those years is now "effectively" untaxed and the Subpart F rules require immediate taxation of that income, the U.S. parent now will have to pay over one million dollars[81] in current taxes even though the French loss and the carryback have no current effect on U.S. taxes.[82] In this scenario, the Subpart F problem is caused not because of non-CFC country sales, but because the high tax exception failed to exempt unrepatriated earnings which had already been assessed at a high rate.

The effective tax rate problem illustrated by this example may be caused not only by loss carrybacks but also by any imaginable combination of differences between the timing of income or deduction recognition for foreign and U.S. purposes.[83] Because of the uncertainties inherent in the high tax exception, most U.S. MNCs cannot project with any accuracy whether income will satisfy the exception and thus be exempt from Subpart F taxation. Consequently, to avoid the harsh effects of Subpart F, a corporation must maintain independent subsidiaries in each of the EC countries where it desires to market its products.[84]

Ironically, Subpart F was never intended to yield such results. In 1962, Congress was primarily concerned with the increasing use of foreign subsidiaries in low tax or no tax ("tax haven") countries.[85] Subpart F was designed to be a penalty which would discourage the transfer of income to a subsidiary principally for purposes of avoiding higher U.S. assessments. As all EC member countries are full tax jurisdictions, rather than tax havens, it is contrary to Congressional intent for Subpart F to apply to the European operations of a U.S. MNC.

At the time of enactment, Congress was also aware that Subpart F

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81. $3 million at the 34% U.S. statutory tax rate = $1.02 million.

82. The foreign loss would have no effect on U.S. taxes since it would not be entered into the foreign tax credit limitation computation; therefore there would be no upward adjustment of the credit amount. I.R.C. § 905, however, requires a readjustment of the current year credit in order to impose current U.S. tax on the refund amount. *See* I.R.C. § 905(c); EC Comments, *supra* note 64, at 4.

83. EC Comments, *supra* note 64, at 5. An example of such a "timing difference" would be depreciation. If a foreign country provides for accelerated depreciation which exceeds the conservative Subpart F depreciation schedules, the U.S. may impose a current tax on the difference. *See* Treas. Reg. T 1.964-1(c)(1)(iii)(b).

84. As the high tax exception does not guarantee the exemption of income, a taxpayer who desires to sell products in various EC countries is left only with the "foreign country" exception to ensure that income will not qualify as Subpart F income. Salmon & Gander, *supra* note 66, at 98.

85. S. REP. No. 1881, 87th Cong., 2d Sess. 78-9 (1962); H.R. REP. No. 1447, 87th Cong., 2d Sess. 57-8 (1962). *See generally* ISENBERGH II, *supra* note 27, at 20-21.

might impair the competitive position of companies engaged in legitimate income-producing activities.[86] Thus, the "foreign country" exception was created, providing that FBCSI would not include CFC country sales.[87] It was apparently Congress' belief that a "subsidiary's 'natural business locus' was the subsidiary's country of incorporation, and that transactions occurring outside that country were likely motivated by U.S. tax avoidance purposes."[88]

In the context of the EC, this assumption does not hold true because a subsidiary's transactions with consumers in other EC countries will involve transactions with other full-tax jurisdictions. Furthermore, because the EC will constitute one single market, it would seem obvious that the "natural business locus" of companies that operate in Europe will expand to include the entire EC.[89] Therefore, to be consistent with Congressional intent regarding the "foreign country" exception, a CFC's "country of incorporation" should be considered the entire EC. It is widely believed, however, that the I.R.C. will not adopt such a position.[90] Thus, a U.S. MNC is effectively relegated to use of only the high tax exception.

The present definition of FBCSI presents a difficult and costly choice for a U.S. MNC: reorganize European operations and lose tax deferral on EC source income, or preserve Subpart F deferral and maintain an inefficient European corporate structure. Unfortunately for American MNCs, this is not a choice which their major competitors must face when determining how to reorganize European operations in response to the existence of a single market.[91]

If the choice is made to maintain separate subsidiaries in each EC member country, U.S. MNCs will be operating at a severe disadvantage in comparison to EC-based and Japanese-based MNCs. Precluded from cap-

86. S. REP. No. 1881, 87th Cong., 2d Sess. 78-9 (1962); *see also* EC Comments, *supra* note 64, at 2-3.

87. This exception is embodied in the definition of FBCSI. *See supra* note 74 and accompanying text.

88. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF U.S. INCOME TAXATION 291 (1987).

89. Salmon & Gander, *supra* note 66, at 101; EC Comments, *supra* note 64, at 3.

90. For an extended discussion of the law regarding the definition of "foreign country," which determines whether the Internal Revenue Service would have a reasonable basis for this conclusion, see EC Comments, *supra* note 64, at 5-7.

91. Japan has an anti-deferral system, yet the denial of deferral extends only to a list of countries officially recognized as tax havens. No EC countries are listed by Japan. PRICE WATERHOUSE, *supra* note 2, at 21; EC Comments, *supra* note 64, at 5. Canada, France, Germany, and the United Kingdom also maintain anti-deferral systems; however, unlike the U.S. system, these countries do not eliminate deferral for active business income. PRICE WATERHOUSE, *supra* note 2, at 21. Other EC countries either exempt foreign earned income from their taxing jurisdiction altogether by unilateral action (e.g., the Netherlands) or by treaty. EC Comments, *supra* note 64, at 5. As their major competitors are not exposed to current taxation on the earnings from foreign subsidiaries, U.S. MNCs will be at a competitive disadvantage whenever the I.R.C. requires current recognition of unrepatriated income. *Supra* note 29 and accompanying text.

italizing on the efficiency related savings the single market will offer, American entities will be unable to cut prices and therefore will be unable to compete effectively, if at all.[92]

The simplest solution to this problem is to amend the definition of FBCSI to include the EC as a single country.[93] That amendment would give U.S. MNCs the same options as in the European corporate reorganizations enjoyed by their European and Japanese rivals. Further, this simple change would leave the high threshold in place to discourage the use of tax havens for avoidance of U.S. taxes.

Such a change would bring the Subpart F rules back into line with original Congressional intent. Congress intended for the rules to discourage the location of subsidiaries in tax havens, yet was careful to include the foreign country exception in order to prevent impairing the effectiveness of a subsidiary in its "natural business locus." When enacted, the "natural business locus," or competitive environment of a subsidiary, was thought to be only a "foreign country."[94] New realities, however, such as creation of a single European market, suggest that redefining a "foreign country" to include the EC would better achieve Congress' aim to protect competitive ability of U.S. MNCs.

2. The All-Inclusive Passive Foreign Investment Company

The PFIC provisions were enacted to close a loophole in the Subpart F rules which had allowed U.S. shareholders of foreign investment corporations to benefit from deferral of taxes on passive income which built up in those businesses.[95]

The provisions were aimed exclusively at companies such as offshore mutual funds whose predominate characteristic was the production of passive income.[96] As enacted, however, the PFIC provisions are so broad that they may ensnare any corporation, from the originally targeted passive income groups to active manufacturing or marketing subsidiaries who inadvertently happen to fail the PFIC test.[97]

Unlike Subpart F, which applies only when certain ownership levels are met, the PFIC rules apply irrespective of the degree of ownership or control by U.S. shareholders. The IRC provides that any foreign corporation is a PFIC if, for any taxable year, either seventy-five percent or more of its gross income is passive, or fifty percent or more of its assets would

92. *See* Salmon & Gander, *supra* note 66, at 100.

93. Such a change has nearly universal support from tax authorities to industry executives. *E.g.* Salmon & Gander, *supra* note 66, at 100; EC Comments, *supra* note 64, at 8; API Statement, *supra* note 25.

94. EC Comments, *supra* note 64, at 8.

95. Tax Council, *supra* note 19. Passive income generally includes interest, rents, and royalties. See I.R.C. §§ 1296(b)(1), 954(c).

96. I.R.C. §§ 1296(b)(1), 954(c); PRICE WATERHOUSE, *supra* note 2, at 161.

97. *See* Tax Council, *supra* note 19; Larkins, *supra* note 72, at 86-7.

produce passive income.[98]

Once the PFIC test is satisfied, a U.S. investor is faced with a costly choice: the shareholder may elect immediate taxation of his share of all of the corporation's income (both passive and ordinary), or, when the shareholder receives an extraordinarily large dividend or sells his interest at a gain, he will have to pay regular tax and an interest penalty for the "privilege" of not being taxed on his share of the income as it was earned.[99] These options are respectively known as the current inclusion and interest charge regimes.

As suggested, any company potentially may qualify as a PFIC, irrespective of the fact that it is primarily engaged in active rather than passive business operations. Under the applicable test, gross income, not gross revenue, is the determinative amount, a figure arrived at by subtracting cost of sales. Obviously, even the most active of subsidiaries may produce no gross income, though substantial gross revenue is generated by active operations. Consider the following:[100] Our bicycle sales subsidiary generates sales revenue of $10 million but has an equal amount of cost of sales. The subsidiary also earns $100 of interest on funds held in its corporate account. Even though passive income is only 0.001% of overall gross revenue, one hundred percent of its income in that year is passive so that our predominantly active subsidiary is a "passive" company for tax purposes.

The relevant test is too easily met, for gross revenue and cost of sales may be equivalent in any given year as a result of a reduction in prices to clear out slow-moving inventory, to attract a greater market share, or to respond to a temporarily unfavorable foreign exchange rate.[101]

An active subsidiary may violate the asset test with similar ease. Two Internal Revenue Service Notices have announced that, for purposes of computing the amount of passive assets, cash and other assets easily convertible into cash, such as inventory, will be considered passive assets even though such holdings are an integral part of active operations.[102]

Assume our subsidiary has a balance sheet as follows: cash ($5 million); trade receivables ($30 million); inventory ($55 million); and property and equipment ($30 million). Based on current IRS positions, our subsidiary will qualify as a PFIC because fifty percent of its assets are passive. Our subsidiary is a PFIC even though all of the assets are used in

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98. I.R.C. § 1296(a); *see generally* ISENBERGH II, *supra* note 27, at 129-152.

99. *See* I.R.C. §§ 1295(a), and 1291(c); John S. Karls, *PFIC/PFC Planning for Active Foreign Subsidiaries*, 2 J. INT'L TAXATION 205 (1991).

100. Example adapted from Karls, *supra* note 99, at 206.

101. *Id.*; AMERICAN BAR ASSOCIATION SECTION OF TAXATION, COMMENTS ON THE COMPETITIVE IMPLICATIONS FOR U.S.-BASED MULTINATIONAL COMPANIES OF THE WRITTEN PROPOSALS ON TAX SIMPLIFICATION IN THE HOUSE WAYS AND MEANS STAFF REPORT RELEASED JUNE 18, 1990 6 (1991) [hereinafter PFIC Comments].

102. *See* I.R.S. Notices 88-22, 1988-1 C.B. 489; 89-81, 1989-2 C.B. 399. *See also* Karls, *supra* note 99, at 206.

its active sales operations and none of the assets generate passive income.

As indicated previously, if either test is satisfied, a shareholder has a choice of electing taxation under either a current inclusion or an interest charge regime. Under a current inclusion regime, a shareholder will be taxed currently on his share of all the earnings of the subsidiary, both ordinary and passive.[103] A shareholder who elects current inclusion treatment therefore subjects himself to a particularly harsh system of taxation which results in complete elimination of deferral for all income from a foreign subsidiary.[104] With an MNC which requires all of the subsidiary's earnings to be reinvested in order to maintain or expand operations, this option can be crippling.[105]

The alternative is no less harsh: Under the interest charge regime, a shareholder must pay interest as well as taxes on the deferred tax liability from the date of qualification as a PFIC or the shareholder's purchase date (whichever is earlier) to the date of a distribution or gain.[106] To illustrate the impact of this penalty, assume the following:[107] The parent of our bicycle subsidiary receives a $60 million distribution in 1992 from the sales subsidiary which represents all of the subsidiary's earnings from 1987 through 1992. If the company qualified as a PFIC in 1988, the $60 million would be allocated equally over the years 1988 through 1992, with interest assessed on the deferral years 1988 through 1991. Assuming an interest rate of twelve percent, the interest liability alone would be $6.1 million.[108]

Basically, the interest charge regime is designed to impose the maximum amount of interest and taxes on the electing shareholder.[109] Because the penalty imposed by this option is so severe, it might not be an option at all and might prevent a U.S. MNC from investing in a foreign subsidi-

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103. I.R.C. § 193(a)(1)

104. *See* Larkins, *supra* note 72, at 90; ISENBERGH II, *supra* note 27, at 145.

105. *Supra* note 29 and accompanying text.

106. I.R.C. § 1291 (a)(1), (c)(2)-(3).

107. Example modified from PFIC Comments, *supra* note 101, at 4-5.

108. *Id.*

109. Several requirements should be noted regarding the calculation of the interest penalty. First, the amount of the distribution is allocated equally to each deferral year, while interest and taxes are assessed for each year irrespective of whether there was an offsetting tax loss in any year. Karls, *supra* note 99, at 207-8. Second, total tax and interest are payable even though the U.S. shareholder may have had excess tax credits in a particular year which would have offset the amount due. *Id.* at 209. Third, prior distributions do not affect the allocation period. *Id.* at 208. Therefore, if a second distribution was made five years later in 1997, interest and taxes would be calculated based on a 1988 through 1996 allocation period, ignoring the fact that all of the 1987 through 1992 earnings had been distributed and taxes and interest paid. Because of longer allocation period, a higher amount of interest and taxes is then assessed. Fourth, the required tax rate is the highest individual or corporate rate for each year. I.R.C. § 1291(c)(2). The bottom line is that interest and taxes easily may exceed one hundred percent of the dividend or gain, thereby eliminating any benefit from the investment. Karls, *supra* note 99, at 209 (extensive computations provided); PFIC Comments, *supra* note 101, at 2.

ary altogether.

Another harsh aspect of the PFIC provisions is that they retain their pre-acquisition status even though they are not held to be a PFIC at the time of purchase.[110] Thus, if a subsidiary desired by an MNC has ever qualified as a PFIC, even if solely in foreign hands at the time, that subsidiary will be a PFIC in the hands of the new purchaser.[111]

A U.S. MNC wanting to enter a market therefore must decide to create a new corporation to purchase a less desirable non-qualifying corporation, or to purchase the desired corporation and bear the burden of proving that it is not a PFIC. As many foreign companies do not retain the necessary information, the latter choice may present a formidable obstacle.[112] Any of the foregoing options, however, represents an uneconomical barrier for a U.S. MNC to enter a new market.[113]

Once the PFIC test has been met, its consequences will continue forever, as a qualifying corporation permanently becomes a PFIC.[114] The classification continues irrespective of the fact that such a status never occurs again.

However, a U.S. shareholder does have the option of cleansing PFIC status once the test is no longer met. Under IRC § 1297(b)(1), a shareholder may elect to recognize all of his unrealized gain with respect to stock investment.[115] Because the calculation of unrealized gain will likely result in a large current tax liability for the shareholder which would require an equal distribution of earnings from the subsidiary, most US investors do not make the election and are saddled with an uneconomical investment.[116]

Further, the election may be made only by those shareholders who were shareholders when PFIC status terminated.[117] Thus, an MNC which desires to purchase a qualifying subsidiary is denied the right to discontinue its status. Should the MNC be unable to secure the election from the prior owners, it will be unprofitable to purchase the subsidiary, and it will be forced to enter the market by purchasing another, possibly less desirable corporation.

The overly broad sweep of the PFIC provisions therefore presents severe disadvantages to U.S. MNCs that desire to conduct active business

110. I.R.C. § 1297(b)(1). *See* PFIC Comments, *supra* note 101, at 3; AICPA, *supra* note 32, at 9.

111. PFIC Comments, *supra* note 101, at 3.

112. *Id.* at 5-6.

113. *See id.*

114. I.R.C. § 1291(a)(1)(B)(ii) (popularly known as the "once a PFIC always a PFIC" rule).

115. Temp. Treas. Reg. T 1297-3T(a), (b)(3); Larkins, *supra* note 72, at 88.

116. *See* Letter from Thomas M. Nee, International President, Tax Executives Institute, Inc., to Donaldson Chapoton, Acting Assistant Secretary for Tax Policy (Aug. 28, 1987), *available in* LEXIS, Tax Notes Int'l, File No. 87 TNI 36-30.

117. Temp. Treas. Reg. T 1.1297-3T(a)(1).

operations abroad. From the outset, a corporation's decision is burdened by problems associated with pre-acquisition PFIC status. Further, an MNC establishing new operations or maintaining existing operations potentially may suffer a complete denial of deferral which may be necessary to sustain ongoing activity or expansion, or may lose most of the benefit of a subsidiary's earnings when distributed.[118] These disadvantages by themselves impair the ability of a U.S. MNC to compete internationally. Additionally, since these disadvantages are not imposed on major foreign rivals, the PFIC provisions can deal a devastating blow to a U.S. MNC.[119]

With CFCs, the anti-competitive effects are magnified. Such corporations are already subject to an anti-deferral regime under Subpart F.[120] However, by violating the gross income or asset test, a CFC may also qualify as a PFIC. The effect is that all of the CFC's income is effectively treated as Subpart F income and denied deferral even though Subpart F would otherwise deny deferral only for a portion of that income.[121]

Subpart F, which applies exclusively to the deferral of CFC income, is therefore rendered inoperative by the PFIC definition. As a result, a CFC is denied the benefit of the high tax and foreign country exception and is taxed in a way totally unintended by Subpart F.[122] In order to correct this defect, the PFIC provisions should be amended to exclude CFCs.[123] This action would merely bring the PFIC provisions to the condition intended when enacted — as a catchall for non-CFCs that escaped Subpart F.[124]

U.S. MNCs do not exclusively conduct business abroad through use of a majority or wholly owned subsidiary.[125] Often new markets are penetrated through a joint venture or other arrangement whereby U.S. ownership is less than that necessary to qualify as a CFC.[126] When a foreign subsidiary with active business operations is not a CFC, a change in the provisions only as to CFCs will not totally remove the disadvantages im-

118. *See supra* note 99 and accompanying text.

119. *See supra* note 91; PFIC Comments, *supra* note 101, at 2.

120. *Supra* note 70 and accompanying text.

121. *See* PFIC Comments, supra note 101, at 9 (*quoting* Letter from Ronald A. Pearlman, Esq., Chief of Staff of the Joint Committee on Taxation, to House Ways and Means Committee (June 18, 1990)).

122. Because all income of the subsidiary, both ordinary and passive, is denied deferral without exception under the PFIC provisions, the high tax and foreign country exceptions of Subpart F are meaningless.

123. Such a change has been called for by tax authorities and industry representatives. *See e.g.* Tax Council, *supra* note 19; API Statement, *supra* note 25; Letter from Robert J. Patrick, Jr., CEO Tax Study Group, to Kenneth W. Gideon, Assistant Secretary of Tax Policy (April 23, 1990), *available in* LEXIS, Tax Notes Int'l, File No. 90 TNI 21-38.

124. *Supra* notes 95-96 and accompanying text.

125. Among the various reasons why a U.S. MNC would not utilize a wholly or majority owned subsidiary are host country restrictions, lack of available capital, or uncertainty regarding the host country and its market. *See* DONALD T. WILSON, INTERNATIONAL BUSINESS TRANSACTIONS 2-3 (2d ed. 1984).

126. *See id.*. CFC (Controlled Foreign Corporation) is defined at *supra* note 70.

posed by the PFIC rules.[127] Therefore, in order to remove the penalties on subsidiaries, specific changes must be made to the PFIC provisions.

The fundamental defect with the provisions is the PFIC definition.[128] As demonstrated previously, the test is too simple to meet. In particular, the asset test is flawed. By including both cash and inventory in the definition of "passive assets," a business such as a sales subsidiary, which generally has only inventory and cash, is especially vulnerable even though none of its assets produce passive income.[129] The test also inherently impairs a company's competitive ability because it encourages such unsound business practices as delaying the collection of accounts receivable to avoid having an excess amount of cash on hand and thereby meeting the test for "passive assets."[130]

The solution to this problem is to exclude from the definition of passive assets cash and inventory which are necessary for active operations.[131] This change would better measure whether assets held by a subsidiary are predominantly for the production of passive income.

The gross income test is similarly flawed. Foreign subsidiaries actively engaged in businesses that happen to incur an operating loss in a particular year should not be classified as a PFIC simply because a small amount of passive income causes the seventy-five percent limit to be exceeded. Because a comparison between gross revenue from operations and passive income would more accurately reflect the predominant characteristic of the business, the test should be changed and based on gross revenue instead of gross income.[132]

Finally, the pre-acquisition status of a foreign subsidiary should be irrelevant.[133] It makes no sense to distort an MNC's investment choice when, at the time of purchase, the subsidiary does not qualify as a PFIC. This change would put the burden on the purchasing MNC to avoid PFIC classification instead of erecting barriers to an investment decision which the MNC has had no role in creating.

V. CONCLUSION

The foregoing examples demonstrate the significant impact the Internal Revenue Code has on the ability of a U.S. corporation to compete internationally. Considering that these few items are only representative of the total number of foreign tax provisions which potentially can have

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127. This is because a change only as to CFCs would not solve the problems associated with taxation of non-CFC's active business operations which occur as a result of defects in the PFIC provisions.

128. *E.g.* PFIC Comments, *supra* note 101, at 6-7.

129. Typically, since a sales subsidiary has only inventory to be sold, cash, and accounts receivable, the test is particularly easy to meet for such operations.

130. *See* Karls, *supra* note 99, at 212.

131. PFIC Comments, *supra* note 101, at 7.

132. *Id.* at 6.

133. *Id.*

adverse effects on a U.S. MNC,[134] it becomes clear that the U.S. tax system is a great threat to U.S. corporations that desire to operate abroad.

Tax writers advance various reasons to justify their treatment of MNCs, ranging from the need to treat U.S and foreign operations of an MNC equally to the need to prevent the export of U.S. capital and jobs.[135] However, when the rhetoric is stripped away, the real reason for the manner in which MNCs are taxed is solely revenue related.[136] Income from international activities represents a lucrative source for taxes which politicians can easily target without fear of popular criticism. As foreign income becomes a larger component of U.S. MNCs' overall earnings, the temptation to overtax this major source of revenue will increase as well.

Throughout the fifties and sixties, when Congress enacted a large portion of the foreign tax provisions, discrimination against MNCs and their foreign sourced income was not a significant issue.[137] The economic dominance of the U.S. in world markets led policy makers to believe that domestic tax policy could not possibly have an effect on the country's overall competitive ability. It was also believed that if foreign countries had inconsistent tax policies, they would follow the U.S. lead and make similar changes.[138]

The realities of the nineties, however, are drastically different from those thirty years ago. Not only has the U.S. lost its dominant economic position but the world itself has dramatically changed. The emergence of common markets such as the EC and the dissolution of the Soviet empire are only the beginning of events which will reshape the global stage on which international competition will occur. Nonetheless, tax writers are engaged in a dangerous mode of thinking. They have continued to enact discriminatory and conflicting laws that subject U.S. MNCs to higher rates of taxation than their competitors, operating on past beliefs rather than present realities. All concerned must realize that such action is a formula for future economic disaster. Even though world income is becoming a larger share of U.S. wealth,[139] the country's share of international markets is decreasing.[140] Thus the establishment of impediments to competition abroad will affect U.S. growth and prosperity.[141]

The U.S. system of taxing the foreign income of MNCs therefore needs to be critically reexamined, an examination that must involve a

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134. *Supra* note 30.

135. *E.g.* PRICE WATERHOUSE, *supra* note 2, at E4-5; ISENBERGH II, *supra* note 27, at 20.

136. *See, e.g.*, AICPA *supra* note 32; *Factors Affecting International Competitiveness: Hearings Before the House Comm. on Ways and Means*, 102d Cong., 1st Sess. (1991) (statement of Chemical Manufacturers Association).

137. *See* PRICE WATERHOUSE, *supra* note 2, at 92.

138. *Id.*

139. *Id.* at 33.

140. *Id.* at 90.

141. *See* RAGLAND, *supra* note 25, at 26.

fundamental change of thought. The focus should shift to enhancing the competitive ability of MNCs rather than compromising that ability solely to maximize present federal revenue, concentrating on harmonizing U.S. tax rules with those of our major competitors.[142] The goal here should be to establish a level playing field so that a U.S. MNC does not pay more tax than a foreign MNC with respect to income earned in the same market. Should harmonization be impossible, U.S. provisions should be restructured with the goals of competitiveness and simplicity in mind.[143]

The economic future of the U.S. is being decided by today's policies. It will surely be tragic if, as the markets of the world become more accessible due to the removal of external barriers, our own country's tax policies become the ball and chain preventing U.S. MNC participation. If the I.R.C. is not reexamined and restructured now, our future prosperity may be disappear in the wake of the competitive advantage of foreign corporations who do not have onerous burdens placed upon them by their governments.

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142. The days are gone when other nations could be expected adopt U.S. tax policies. Thus, many significant differences now exist between the way U.S. MNCs are taxed compared to their foreign competitors. This lack of harmonization is one of the key factors causing U.S. MNCs to pay higher effective income taxes than MNCs chartered in other industrialized nations. PRICE WATERHOUSE, *supra* note 2, at 94. A tax policy of harmonization is necessary to the establishment and retention of the competitive position of U.S. MNCs. Otherwise, U.S. MNCs must struggle on an unequal playing field, contending against foreign corporations as well as our own tax code. See API Statement, *supra* note 25. *See generally* PRICE WATERHOUSE, *supra* note 2, at 92-96.

143. *See* RAGLAND, *supra* note 25, at 26.

Treasury Regulation of International Wire Transfer and Money Laundering: A Case for a Permanent Moratorium

I. Introduction

The basis of virtually every international business transaction is a transfer of assets in the form of currency, instruments or other goods or services as consideration for that transaction. Modern technology has contributed greatly to the speed and efficiency of funds transfers connected with these transactions.

Electronic funds transfers are "a series of messages to and through one or more banks that are intended to result in the payment of funds from one person to another."[1] This is accomplished through the electronic debiting of the account of the "originator" or person sending the money and a corresponding credit to the "beneficiary" or the person receiving the funds.[2] No cash is physically transported in this type of transaction. The speed and efficiency of this system has helped facilitate the expansion of international trade by making the payment process less cumbersome and, in fact, almost instantaneous.

This ease and facility has unfortunately also provided an efficient system by which to "launder" illicit cash proceeds from criminal activity such as narcotics trafficking.[3] Laundering such illegal proceeds into usable, apparently legitimate assets is essential for many criminal enterprises. Estimates of the amount of money illegally laundered for all purposes range from $100 billion to $300 billion annually.[4] Once absorbed into the system, this "dirty money" becomes increasingly difficult to dis-

1. Proposed Amendment to the Bank Secrecy Act Regulations, 55 Fed. Reg. 41,696 (1990), *to be codified at* 31 C.F.R. pt. 103 (proposed Oct. 15, 1990). "Electronic funds transfers" is a term used in statutes and regulations domestically and will be used interchangeably with the terms "wire transfer," "electronic payments," and "electronic transfer" throughout this article.

2. *Id.*

3. "Nowhere . . . is the need for money laundering more important than in the illicit drug trade — a cash business with estimated U.S. sales in excess of $100 billion annually." U.S. GEN. ACCT'G OFC., REPORT TO THE CHAIRMAN, SUBCOMMITTEE ON TERRORISM, NARCOTICS AND INTERNATIONAL OPERATIONS, COMMITTEE ON FOREIGN RELATIONS, U.S. SENATE, MONEY LAUNDERING: THE U.S. GOVERNMENT IS RESPONDING TO THE PROBLEM, GAO/NSIAD-91-130, at 2 (May 1991) [hereinafter 1991 GAO Report].

4. U.S. GEN. ACCT'G OFC., REPORT TO THE CHAIRMAN AND RANKING MINORITY MEMBER, SUBCOMMITTEE ON TREASURY, POSTAL SERVICE AND GENERAL GOVERNMENT, COMMITTEE ON APPROPRIATIONS, U.S. SENATE, MONEY LAUNDERING: TREASURY'S FINANCIAL CRIMES ENFORCEMENT NETWORK, GAO/GGD-91-53, at 2 (Mar. 1991).

tinguish from legitimate funds.[5] Commingling encourages criminal activity by allowing perpetrators to benefit from their illegally derived cash proceeds. Thus, money laundering has been described as a "dirty needle" injecting and infecting legitimate markets with the disease of greed.[6] Illicit cash proceeds are injected into the financial system, aggregated into one or more accounts of seemingly legitimate business ventures, and then "wired" to anywhere in the world.[7]

Efforts by government authorities worldwide to curb such abuses have become a higher priority recently.[8] These efforts are directed toward both currency and non-currency transactions. Efforts in the non-currency area are creating a dilemma for government officials and financial institutions, as many of these illicit transactions appear deceptively similar to legitimate banking transactions.[9] Regulation of this highly efficient and beneficial system of wire transfers must be deliberatively and carefully weighed against the burden placed on the legitimate businesses affected. This article describes the wire transfer process, money laundering mitigation efforts and recent proposals by the United States Treasury Department.

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5. U.S. electronic funds transfer systems process over $1.2 trillion dollars daily. *See infra* notes 16-19 and accompanying text.

6. Gerald Lewis, Comptroller, State of Florida, Speech to the International Symposium on Money Laundering, Coral Gables, Florida, sponsored by the University of Miami's Graduate School of International Studies (Oct. 26, 1989), *reprinted in Drug Money Laundering Control Efforts: Hearing Before the Subcomm. on Consumer and Regulatory Affairs of the Senate Comm. on Banking, Housing, and Urban Affairs*, 101st Cong., 1st Sess. 492 (1989) [hereinafter *Control Efforts*].

7. As drug peddlers expand their markets, they also diversify their money laundering techniques. Law enforcement agencies are discovering money laundering activity in enterprises not usually associated with such activity. For example, beauty salons, camera shops, car rentals, dry cleaners, movie houses, fitness clubs, pet shops and even grocery stores are utilized as legitimate business fronts to facilitate the infusion of large amounts of cash into the international payments system. *Id.* at 26.

8. Examples of such efforts include: the United Nations Vienna Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (December, 1988); INTERPOL; the Basel Committee on Banking Regulations and Supervisory Practices (comprised of central bank governors); the Inter-American Drug Abuse Control Commission (CICAD) of the Organization of American States; and the Financial Action Task Force, established at the July, 1989 Paris Economic Summit of G-7 Countries and the President and Commission of the European Community. Also invited to participate in the Task Force were Denmark, Finland, Greece, Ireland, New Zealand, Norway, Portugal, Turkey, Hong Kong and the Gulf Cooperation Council. In April of 1990, the Task Force issued a report containing forty recommendations for an international effort to combat money laundering; *see* 1991 GAO Report, *supra* note 3, at 58-63. *See generally* Laura M. L. Maroldy, *Recordkeeping and Reporting in an Attempt to Stop the Money Laundering Cycle: Why Blanket Reporting and Recording of Wire and Electronic Funds Transfers is Not the Answer*, 66 NOTRE DAME L. REV. 863 (1991) [hereinafter *Blanket Reporting*]; Jeffrey Lowell Quillen, Note, *The International Attack on Money Laundering: European Initiatives*, 1991 DUKE J. COMP. & INT'L L. 213 (1991) [hereinafter *European Initiatives*].

9. *See Control Efforts*, *supra* note 6, at 81-88 (testimony of Chuck Morley of the Morley Group, Inc., financial consultants).

II. ELECTRONIC FUNDS TRANSFERS[10]

Before the age of microprocessors, funds transfers between banks were made primarily over international and domestic telegraph and telex networks.[11] This system was very time consuming and cumbersome. Telexes were required to be processed manually and there was no standardized format; each bank typically designed its own forms.[12]

Because these telexed instructions were nonuniform, it was not possible to process transactions without the participation of a human operator reviewing and interpreting the instructions on the transaction. There was no standard way to indicate the parties of the payment, the amount, the currency, the value, the date, etc.. This archaic system was chaotic, requiring a large staff of handlers and voluminous paperwork.[13]

Technological advancement in the development and implementation of computers has both increased the speed by which such wire transfer transactions can be accomplished and provided for a steady evolution of standards relating to the communication networks and automated systems that support the banking industry.[14] It is now possible to effect funds transfers that are processed and interpreted entirely electronically, without the involvement of human translators.

There are three primary communications systems facilitating wire transfers: the Federal Reserve Communications System ("Fedwire"); the Clearing House Interbank Payments System ("CHIPS"); and the telecommunications system run by the Society for Worldwide Interbank Financial Telecommunications S.C. ("SWIFT"). Fedwire is the nation's primary wholesale electronic funds transfer system[15] utilized by the banking

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10. Electronic and wire transfers can move funds in a matter of seconds, because what is being "moved" is not physical currency, but electronic messages. An authority on electronic funds transfers noted:

> Money itself is nothing but information. It represents the claims that individuals and institutions have for goods and services that exist within an economy. The possession of money in paper form is simply the possession of a certificate which records these particular claims. The movement of money is the movement of these claims through the accounting records of the financial, industrial and merchandising communities.

Blanket Recording, *supra* note 8, at 864 n. 9 (citing D. CHORAFAS, ELECTRONIC FUNDS TRANSFER (1988)).

11. *See Control Efforts*, *supra* note 6, at 89-141 (testimony of Joseph Madison, President of Joseph Madison Associates, Inc., a consulting firm for computer technology for banks).

12. *Id.*

13. *Id.*

14. *Id.* It has been said that these electronic systems have become "the" banking system of the global economy. *See* Philip S. Corwin and Ian W. Macoy, *A Comprehensive Look at Electronic Payments System Risk*, BANKING EXPANSION REP., Feb. 5, 1990.

15. "Wholesale electronic funds transfer generally refers to a funds transfer used to satisfy an immediate, high-dollar obligation or to enable the recipient to make immediate use of the funds." U.S. GEN. ACCT'G OFC., BRIEFING REPORT TO THE CHAIRMAN, SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE, COMMITTEE ON ENERGY AND COMMERCE, HOUSE

industry to handle the payments banks make to each other on behalf of themselves and their customers.[16] CHIPS is the principal electronic funds transfer system that supports the international transfer of funds between the United States and international banks.[17] Together, CHIPS and Fedwire account for *daily* transactions of over $1.2 trillion.[18] These systems handle more than ninety-five percent of all wire transfers received or sent in the world.[19] SWIFT is an international message processing system that is the mainstay for initiating international electronic funds transfers through Fedwire and CHIPS.[20]

A. *Fedwire*

The Fedwire payment network is operated by the U.S. Federal Reserve System. Fedwire, in existence in some form since 1918,[21] connects the twelve Federal Reserve Banks and their twenty-five branches (e.g., Denver is a branch of the Kansas City Federal Reserve Bank), U.S. government agencies (e.g., Treasury), and some ten thousand depository institutions.

Fedwire has evolved from a teletype, terminal-based system to today's direct-link, computer-based system.[22] In 1987, Fedwire processed about fifty-five million fund transfers with a combined value of $153 trillion — over $695 billion on average every business day.[23] In 1990, this daily transaction rate was $792.8 billion — with an annual dollar volume of almost $200 trillion dollars.[24] Transfers over Fedwire are considered both immediate and irrevocable because the Federal Reserve guarantees payment to the recipient financial institution upon completion of the transfer.[25]

Fedwire is entirely under the regulatory authority of the Federal Reserve System. The Federal Reserve Board examines Fedwire operations during annual financial examinations of reserve bank activities.[26] In addi-

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OF REPRESENTATIVES UNITED STATES GENERAL ACCOUNTING OFFICE, ELECTRONIC FUNDS TRANSFER: INFORMATION ON THREE CRITICAL BANKING SYSTEMS, GAO/IMTEC-89-25BR, at 2, n. 1 (Feb. 1989) [hereinafter 1989 GAO Briefing].

16. *Id.* at 2.

17. *Id.* at 3.

18. *See id.* at 2-3.

19. *Wire Transfer Rules Proposed, 40,000 Are Affected*, MONEY LAUNDERING ALERT, Nov. 1990, at 1.

20. 1989 GAO Briefing, *supra* note 15, at 2.

21. *Id.*

22. *Control Efforts*, *supra* note 6, at 105 (Madison testimony).

23. 1989 GAO Briefing, *supra* note 15, at 2.

24. Letter from Philip Corwin, Director and Counsel, American Bankers Association, to Peter G. Djinis, Acting Director, Office of Financial Enforcement, Department of the Treasury 5 (Jan. 15, 1991) (comment letter on the Proposed Amendment to Bank Secrecy Act Regulations Relating to Recordkeeping for Funds Transfers by Banks, on file with the author) [hereinafter Corwin letter].

25. 1989 GAO Briefing, *supra* note 15, at 2.

26. *Id.* at 4.

tion, internal auditors of the various Federal Reserve district banks conduct periodic audits that include a review of Fedwire activities.[27]

B. *CHIPS*

CHIPS was created in 1970 and is the nation's major wholesale electronic funds transfer system for processing international U.S. dollar transfers among international banks.[28] It is a private-sector system which electronically processes international transactions for about 140 domestic depository institutions and branch offices of foreign banks. CHIPS moves dollars between participant banks for transactions, including letters of credit, collections, reimbursements, foreign exchange, and the sale of short-term Eurodollar funds. In 1987, the number of CHIPS transfers approached thirty-two million with a combined value of almost $140 trillion, or over $554 billion on average every business day.[29] In 1990, CHIPS processed about thirty-seven million transactions valued at $222 trillion.[30]

Regulation of CHIPS is conducted under the combined authority of the Comptroller of the Currency, the Federal Reserve System, and the Federal Deposit Insurance Corporation and is examined every eighteen months by a team of examiners.[31]

C. *SWIFT*

SWIFT came into being in 1977 and is designed to facilitate the electronic communications needs of international banking.[32] The Society for Worldwide Interbank Financial Telecommunications S.C. operates the SWIFT telecommunications system, which was created to provide international automated message processing and transmission services between banks. It is a Belgian cooperative society that is owned and managed by almost 1500 financial institutions worldwide.[33] SWIFT is not a system for the transfer of funds, but of information via messages, which allow institutions to transmit among themselves instructions on international payments, statements and other transactions associated with international finance. The SWIFT system connects about 2400 institutions, including non-banking institutions, in almost sixty countries. It processes about one million messages daily relating to fund transfers accomplished

27. *Id.* at 5.
28. *Id.* at 3.
29. *Id.*
30. 1991 GAO Report, *supra* note 3, at 13.
31. The authority to review CHIPS is dictated by the Bank Service Corporation Act of 1962, 12 U.S.C. § 1867. This Act generally governs the "backroom" operations of banks that are under the authority of the various federal regulators, including such activities as clerical, accounting, and statistical functions. CHIPS officials dispute whether there is specific statutory authority within the Act for this examination. However, the officials have taken it upon themselves to allow such investigations by formally "inviting" the examiners. This cooperation has eliminated the need to settle the dispute. 1989 GAO Briefing, *supra* note 15, at 5.
32. *Id.* at 3.
33. *Id.*

through Fedwire and CHIPS.[34]

SWIFT is not subject to U.S. federal regulation. Examination of SWIFT operations is carried out by in-house auditors on a periodic basis. Additionally, an annual review is conducted by private, outside-auditors to assure the integrity of the security and confidentiality of SWIFT messages.[35]

D. *Private Networks*

Many large money center banks have developed private networks in response to customers' cash management needs and to assist in their foreign branch and correspondent operations. These networks are offered to corporate customers and to "correspondent" banks, typically smaller banks utilizing the resources of their larger cousins, for a fee of course.[36] Thus, even the smallest of depository institutions can access and transmit funds for their customers or for their own accounts through the complex, sophisticated international network of wire transfers.[37] The American Bankers Association has developed standards for its members so that these private networks for funds transfer are compatible with SWIFT, CHIPS and Fedwire. In fact, CHIPS and Fedwire implemented the ABA standards, which were essentially derived from SWIFT.[38]

All of the above systems are fully compatible, integrated and automated. They are utilized singularly and in unison to effect funds transfers in tremendous volume virtually instantaneously on a worldwide basis, from and to any place on the globe.[39] The standardization of national

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34. *Id.* at 4.
35. *See id.* at 4-6.
36. *Control Efforts*, *supra* note 6, at 108 (Madison testimony).
37. Such private systems include: Bankers Trust Cash Connector; Morgan Guaranty's MARS; Chase Manhattan's Current Day Reporter; Chemical Bank's CHEMLINK; and First National Bank of Chicago's FirstCash systems. *Id.*
38. *Control Efforts*, *supra* note 6, at 118 (Madison testimony).
39. 1989 GAO Briefing, *supra* note 15, app. I. Some examples of this interconnection are as follows:

Example 1, Domestic: A Washington D.C. purchaser buys $2 million in goods from a Los Angeles manufacturer. He goes to his bank to initiate a payment order. The purchaser's bank, a member of the Federal Reserve, is linked to Fedwire and uses a computer terminal to send a funds transfer message to its district Federal Reserve Bank in Richmond, Va. Automatically proceeding over Fedwire to the manufacturer's Federal Reserve district bank in San Francisco, the funds transfer message is then instantaneously sent to the manufacturer's local bank in Los Angeles via Fedwire. The local bank credits the manufacturer's account immediately. Non-Federal Reserve member banks can accomplish the same through a correspondent relationship with a member bank or through a private system. *Id.*

Example 2, International: A British importer orders goods from a French manufacturer to be paid in U.S. dollars. After the goods have been received, the British importer instructs its London bank to send payment to the French manufacturer's bank in Paris. The London bank uses the SWIFT system to advise its New York branch office to send payment to the manufacturer's French bank. The electronic funds transfer is sent through CHIPS to the New York branch of the French bank. The New York branch office of the French bank laws generally affecting these international electronic funds transfers is a topic which has been the subject of extensive discussion over the past several years[40] and which in itself is a suitable basis for an entire article; it is not pursued further here.[41]

III. MONEY LAUNDERING

The above-described systems for instantaneously moving funds around the globe have proven quite attractive to those who illicitly accumulate and distribute large amounts of cash. Although estimates on the exact amount of funds vary, authorities believe that up to $85 billion of over $120 billion of drug money proceeds are laundered or invested annually.[42]

Money laundering has been defined as "the process whereby one conceals the existence, illegal source, or illegal application of income, and then disguises that income to make it appear legitimate."[43] Illegal drug

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notifies its Paris office through SWIFT of the receipt of payment. The Paris bank credits the manufacturer's account. *Id.*

Example 3, International: A Los Angeles importer instructs its local bank to send payment to a Paris manufacturer for goods received. The Los Angeles importer's bank, linked to Fedwire, sends a funds transfer message to its district Federal Reserve Bank in San Francisco. This message automatically goes to the Federal Reserve Bank in New York. The message is automatically relayed via Fedwire to a New York correspondent bank of the Paris bank. The correspondent bank advises the manufacturer's bank in Paris via SWIFT to send payment to the French manufacturer. The payment order is received by the manufacturer's Paris bank and the funds are available on demand from the manufacturer. *Id.*

40. The United Nations Commission on International Trade Law (UNCITRAL) has undertaken a project to prepare a model national law on electronic funds transfers. The U.S. Secretary of State's Advisory Committee on Private International Law Study Group on International Electronic Transactions has met and considered various proposals for positioning the U.S. delegation to this UNCITRAL project. The U.S. delegation will be advocating adoption of a model national law which is essentially Article 4A of the Uniform Commercial Code of the U.S.. Telephone conversation with Harold S. Burman, Office of the Legal Adviser, U.S. Department of State, on December 20, 1991.

41. For a more in-depth analysis of the problems of disparate treatment under international law because of a lack of uniform standards for wire transfers, see Jeffrey S. Tallackson and Norma Vallejo, *International Commercial Wire Transfers: The Lack of Standards*, 11 N.C. J. INT'L & COM. REG. 639 (1986), and Shawn E. Flatt, *Citibank, N.A. v. Wells Fargo Asia LTD.: A Threat to U.S. International Banking?*, 1991 DUKE J. COMP. & INT'L L. 241 (1991).

42. Financial Action Task Force on Money Laundering, Report of February 7, 1990, at 3-4 (on file with the author) (G-7 and other invited countries convened to work towards unified international proscriptions for money laundering); *see also* 1991 GAO Report, *supra* note 3, at 12.

43. PRESIDENT'S COMMISSION ON ORGANIZED CRIME, INTERIM REPORT TO THE PRESIDENT AND THE ATTORNEY GENERAL, THE CASH CONNECTION: ORGANIZED CRIME, FINANCIAL INSTITUTIONS AND MONEY LAUNDERING, at 7 (1984) [hereinafter THE CASH CONNECTION]. Though the legitimate world payments systems have fostered the evolution of a relatively cashless society, cash has assumed an even greater importance as the medium of exchange within the criminal world. Jonathan J. Rusch, *Hue and Cry in the Counting House: Some Observations on the Bank Secrecy Act*, 37 CATH. U.L. REV. 465 (1988); *Changes in the Use of*

money proceeds derived from sales of cocaine, heroin and cannabis certainly constitute a major portion of the illicit cash proceeds that are injected into the financial system; however, activities such as illegal gambling, extortion, bribery, loansharking and prostitution also generate large amounts of cash needing to be legitimized.[44] Money laundering could also be used by a corporation seeking to cover the trail of bribery money paid to foreign officials in violation of the Foreign Corrupt Practices Act.[45]

Electronic funds transfers can be and are used by criminals to launder money. It has been said that wire transfers "have emerged as the primary method by which high-volume money launderers ply their trade."[46] Wire transfers, however, are not the only way to move illicit money; "dirty money" can be moved into international channels in myriad ways. The most pervasive method of laundering money is physically smuggling currency and/or financial instruments across borders.[47] Money can also be laundered internationally by purchasing commodities such as cars, appliances, or precious metals and shipping them abroad to be sold for local currency, or by fraudulently invoicing international commercial transactions.[48]

Currently, the normal system of money laundering consists of cash being moved into banks and other financial institutions and then being wired offshore or to other domestic banks for the purchase of assets.[49] In some areas, money launderers have injected large volumes of cash into real estate markets; drug traffickers make large cash down payments and full price purchases of real estate. The impact of this activity distorts true market conditions, as these purchases are typically at inflated prices.[50] An example of this would be as follows: A launderer creates an apparently legal property management firm in the United States. This management firm manages property of "third parties." The launderers aggregate currency, send it offshore, put it through a series of offshore money laundering havens, then bring the funds back into the United States as loans, or as investment funds that are used to buy real estate that the management company sells and then manages.[51]

Transaction Accounts and Cash from 1984 to 1986, 73 FED. RES. BULL. 179, 191 (1987) (almost 90% of the total $177.4 billion of coin and currency in circulation outside banks was "apparently held in unreported hoards, 'underground' for illegal purposes, or offshore").

44. *See Blanket Reporting*, *supra* note 8, at 865.

45. 15 U.S.C. § 78(dd-1) (unlawful to make payment or the promise of payment by any means to a foreign official for the purposes of influencing an act or decision of the official in his official capacity).

46. Rebecca Cox, *New Path for Money Laundering*, THE AMERICAN BANKER, July 24, 1989, at 9 (letter from Donald G. Ogilvie, Executive Vice President, American Bankers Association to William J. Bennett ("Drug Czar"), then-director of the Office of National Drug Control Policy).

47. 1991 GAO Report, *supra* note 3, at 14.

48. *Id.*

49. *Control Efforts*, *supra* note 6, at 81 (Morley testimony).

50. *Id.* at 26 (testimony of Gerald Lewis).

51. *Id.* at 81 (Morley testimony).

Identifying the amount of illegal funds that are laundered internationally is difficult. Huge sums are transferred electronically each day in connection with conventional banking activities such as collections, reimbursements, letters of credit and foreign exchange transactions.[52] The large volume of currency and monetary instruments that legitimately traverse borders make identifying illegal funds difficult, since these funds are often mixed with and are indistinguishable from legitimate currency, cashier's check and bearer bond transactions.[53]

While cash provides criminal enterprises with a ready medium of exchange, the sheer physical volume of such mountains of paper can prove quite a challenge. According to U.S. Customs Service reports, U.S. currency notes weigh about one gram each, with about 450 bills to the pound.[54] Fifty pounds of ten-dollar bills is $227,000.[55] A million dollars in twenty-dollar bills weighs 113 pounds.[56] Because of this logistical problem, money laundering has become increasingly sophisticated and is evolving into a highly specialized field. Illicit transactions are more and more often being carried out by independent money laundering experts working for a percentage of the laundered funds.[57]

Typical money laundering activities follow three basic steps: placement, layering and integration.[58] Placement implements the physical disposal of bulk currency through various means, including the commingling of funds with legitimate business proceeds, smuggling and converting cash into deposits or assets at banks.[59] Due to statutory and regulatory requirements of reporting currency transactions of $10,000 or more,[60] this process can involve "structuring"[61] where deposits are made in increments of less than $10,000, or "smurfing," in which couriers, or "smurfs," make multiple purchases of money orders, cashiers checks, or other finan-

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52. 1991 GAO Report, *supra* note 3, at 13.

53. U.S. Customs Service data show that during 1989, almost $56 billion in cash and monetary instruments moved into and out of the United States. This figure is most likely understated, because many legitimate and routine international banking transactions are currently exempt from the reporting requirement of the Bank Secrecy Act. *Id.*

54. *Id.*

55. *Id.*

56. *Money Laundering in Florida: Banking Compliance, Federal Enforcement Measures, and the Efficacy of Current Law, Hearing Before the Subcommittee on Consumer and Regulatory Affairs of the Senate Committee on Banking, Housing and Urban Affairs*, 101st Cong., 1st Sess. 500 (1989) (statement of Charles Intriago, Publisher, Money Laundering Alert) (how Federal agencies assigned to money laundering operations carry out their assignments in Florida, what statutory tools they use to carry out their investigations, and the particular problems financial institutions face when operating in a region known to be a major port of entry for drugs and a major port of exit for drug profits) [hereinafter *Money Laundering in Florida*].

57. 1991 GAO Report, *supra* note 3, at 13.

58. *Id.* at 14.

59. *Id.*

60. *See infra* note 75 and accompanying text.

61. 1991 GAO Report, *supra* note 3, at 14 n.1.

cial instruments in smaller increments.[62]

This infusion of cash into the legitimate economy is the most critical for criminal enterprise. Banks are not the only conduit for this infusion; launderers also utilize other financial institutions such as casinos, check cashing establishments, currency exchanges, and securities brokers, as well as non-traditional channels such as underground banking systems that deal in barter that are prevalent in the Republics of the former Soviet and Eastern block nations where official economies are in shambles.[63]

Layering is aggregating funds within accounts and transferring those funds electronically.[64] Integration occurs when the laundered funds are injected back into the legitimate economies, apparently derived from legal sources such as real estate deals, loans from front companies and fraudulent import and export invoicing as discussed above.[65] The only difference between criminal and legitimate transactions at this point is the initial source of the cash. To identify what is, in fact, a money laundering operation, one must associate the funds involved, or the person controlling, depositing or transferring those funds, with some illegal activity.[66]

The magnitude of criminally sophisticated manipulation of otherwise legitimate commercial pathways has caused great consternation within governments and the private sector worldwide. Over the past twenty-five years, statutes, regulations and private efforts to curb such abuses have been enacted, yet the problems persist. New initiatives have been enacted and proposed to enhance the effectiveness of past efforts.

IV. GOVERNMENT EFFORTS TO CURB MONEY LAUNDERING

"Without the ability to freely utilize its ill-gotten gains, the underworld will have been dealt a crippling blow."[67] Attacking the profits of the drug trade is predicted to eventually prove more effective in combating drugs in society than all other combined efforts on eradication and interdiction.[68] There is increasing pressure internationally to clamp down on drug money laundering and its accompanying scandals, such as the one concerning the Bank of Credit and Commerce International (BCCI). The government of Japan,[69] the European Community,[70] Central and

62. *Id.* Originally, "smurfs" referred to small numerous gnome-like cartoon characters with blue complexions. I could not locate the origin of use in this context, but it is a common reference for this particular type of laundering technique.

63. *See generally* 1991 GAO Report, *supra* note 3, at 14.

64. *Id.*

65. *Id.*

66. *Blanket Reporting*, *supra* note 8, at 867.

67. THE CASH CONNECTION, *supra* note 43, at iii (statement of Irving R. Kaufman, Chairman of the President's Commission on Organized Crime); *see also Blanket Reporting*, *supra* note 8, at 863.

68. 137 CONG. REC. 4203, 4206 (daily ed. June 10, 1991) (statement by Congressman Annunzio).

69. *Teenage Drug Abuse Grows Rapidly in Japan*, The Reuter Library Report, Au-

South American nations,[71] as well as the federal and state governments in the United States[72] are undertaking to broaden and strengthen money laundering controls. The banking industry itself has begun massive efforts to curb abuses.[73]

A. *United States*

The core statutory enactments governing currency transaction reporting and recordkeeping are found within the provisions of the Bank Secrecy Act,[74] administrated by the Department of the Treasury. These provisions are designed to assist in the detection and prosecution of money laundering violations through the collection and in some cases reporting of data which is available to enforcement officials within the U.S. Customs Service, Internal Revenue Service, Office of Financial Enforcement, the Department of Justice and the Office of Financial Crime Enforcement Network (FINCEN).[75]

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gust 13, 1991 ("Police have drafted new regulations to control money-laundering related to drugs and stricter laws against gangsters involved in the business. Parliament is expected to approve the regulations later this year.").

70. *See generally European Initiatives, supra* note 8; *see also Banking and Financial Services*, European Update, November 28, 1991 at 59-67, *available in* WESTLAW, Eurupdate database [hereinafter European Update].

71. The Document of Cartegena, signed by the presidents of Columbia, Peru, Bolivia and the United States at the February 1990 Andean Summit, included provisions under which the parties agreed to:

* identify, trace, freeze, and seize drug money proceeds;
* attack the financial aspects of the drug trade;
* criminalize money laundering;
* provide exceptions to banking secrecy; and
* implement a system for forfeiting and sharing drug proceeds.

Also, a panel was established at the 1990 Organization of American States Ministerial Meeting to draft model regulations concerning criminalization of money laundering, asset seizure and currency transaction reporting. 1991 GAO Report, *supra* note 3, at 62.

72. *See, e.g., N.Y Enacts Law Aimed at Illegal Transmitters*, MONEY LAUNDERING ALERT, Aug. 1990, at 8 (broadened definition of "financial institution" in state penal code to include unlicensed money transmitters, auto and boat sellers, and real estate brokers).

73. In January of 1989, the American Bankers Association established the Money Laundering Task Force to address all possible methods of stopping the flow of illicit funds. Corwin letter, *supra* note 24, at 2.

74. Amendments to the Federal Deposit Insurance Act (Bank Secrecy Act) Titles I and III, Pub. L. 91-508, 84 Stat. 1114-1124 (1970), *codified at* 12 U.S.C. §§ 1730(d), 1829(b), 1951-1959; 18 U.S.C. § 6002; 31 U.S.C. § 321, 5311-5314, 5316-5322 (1988).

75. The Financial Crimes Enforcement Network (FINCEN) was established by order the Secretary of the Treasury to provide a government-wide, multisource intelligence and analytical network in support of the detection, investigation, and prosecution of domestic and international money laundering and other financial crimes by federal, state, local and foreign law enforcement agencies. It is important to note that FINCEN has no authority to conduct independent investigations but is designed to assist, with tactical and strategic information resources, those organizations with proper investigatory authority. *See* Organization, Functions, and Authority Delegations: Financial Crimes Enforcement Network, 55 Fed. Reg. 18433-03 (1990) (Dept. of Treasury Notice); *see also* U.S GEN. ACCT'G OFC., REPORT TO THE CHAIRMAN AND RANKING MINORITY MEMBER, SUBCOMMITTEE ON TREASURY, POSTAL SER-

The Bank Secrecy Act reporting requirements include the Currency Transaction Report (CTRs) and the Report of International Transportation of Currency or Monetary Instruments (CMIRs).[76] Generally, CTRs and CMIRs are required when customers of financial institutions make transactions at or exceeding $10,000 dollars in currency, or in the case of CMIRs, of currency or financial instruments of any kind that are transported into or out of the United States. The Act also requires the Report of Foreign Bank and Financial Accounts, which must be filed by persons with signature authority or a financial interest in foreign bank security or deposit accounts at or exceeding $10,000 dollars.

Financial institutions[77] must file these currency transaction reports with the Internal Revenue Service within fifteen days following the reportable transaction.[78] CMIR reports are filed with the Commissioner of Customs. If currency is transported, the filing must occur at the time of entry into the United States.[79] The recipient is required to file within fifteen days of receipt.[80]

Financial institutions must provide the identity and the occupation of the individual who conducted the transaction with the financial institution, the identity of the individual on whose behalf the transaction was

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VICE AND GENERAL GOVERNMENT, COMMITTEE ON APPROPRIATIONS, U.S. SENATE, MONEY LAUNDERING: TREASURY'S FINANCIAL CRIMES ENFORCEMENT NETWORK, GAO/GGD-91-53 (Mar. 1991).

76. 31 U.S.C. §§ 321, 5311-5314, 5316-5322 (1988).

77. "Financial Institution" is defined by the regulations to mean:

> . . . each agent, agency, branch, or office within the United States of any person doing business, whether or not on a regular basis or as an organized business concern, in one or more of the capacities listed below:
>
> (1) a bank (except bank credit card systems);
>
> (2) a broker or dealer in securities;
>
> (3) a currency dealer or exchanger, including persons engaged in the business of check cashing;
>
> (4) an issuer, seller or redeemer of travelers checks or money orders, except as a selling agent exclusively who does not sell more than $150,000 of such instruments within a given 30 day period;
>
> (5) a licensed transmitter of funds, or other person engaged in the business of transmitting funds;
>
> (6) a telegraph company;
>
> (7)(i) a casino or gambling casino licensed as a casino or gambling casino by a state or local government and having gross annual gaming revenue in excess of $1 million;
>
> (7)(ii) a casino or gambling casino includes the principle headquarters and any branch or place of business of the casino or gambling casino;
>
> (8) a person subject to supervision by any state or federal bank supervisory authority;
>
> (9) the United States Postal Service with respect to the sale of money orders.

31 C.F.R. § 103.11(i) (1991).

78. 31 C.F.R. § 103.27 (1991).

79. 31 C.F.R. § 103.23 (1991).

80. *Id.*

conducted, the account number involved in the transaction, and a description of the transaction.[81]

The Bank Secrecy Act recordkeeping and reporting requirements apply only to domestic financial institutions and foreign banking entities doing business in the United States. The Act does not extend to financial institutions offshore, even if it is a branch of a U.S. institution doing business outside U.S. borders.[82]

While the Bank Secrecy Act was enacted in 1970, enforcement was virtually non-existent until the mid-1980s. The Bank Secrecy Act was originally designed to help deter white collar crime, such as income tax evasion, by furnishing law enforcement officials with greater evidence of illegal financial transactions.[83] In 1985, the U.S. Senate Permanent Subcommittee on Investigations fully disclosed the money laundering scandal at the Bank of Boston. The impact of this scandal on compliance was dramatic: CTR filings by financial institutions in 1984 numbered only 700,000, but in 1989 reached almost seven million.[84]

The Bank Secrecy Act regulations authorize the Secretary of the Treasury to "target" transactions with certain foreign institutions[85] and transactions of domestic financial institutions that take place in certain geographic regions of the United States.[86] These additional regulations provide the Secretary with broad discretion to channel his resources to particular institutions and regions that might be more prone to abuses

81. *Blanket Reporting*, *supra* note 8, at 873.

82. 1991 GAO Report, *supra* note 3, at 15 (Foreign banks and foreign branches of U.S. banks are subject to host country regulations. Such reporting could violate host country secrecy laws.).

83. Cliff E. Cook, *Complying with the Spirit of BSA: "Know Your Customer" Policies and Suspicious Transactions Reporting*, ABA BANK COMPLIANCE, Summer 1991, at 7 [hereinafter *Know Your Customer*].

84. *Control Efforts*, *supra* note 6, at 85 (Morley testimony).

85. 31 C.F.R. § 103.25(a) (1991) (the Secretary, when he deems appropriate, may promulgate regulations requiring specified financial institutions to file reports of certain transactions with designated foreign financial agencies).

86. If the Secretary of the Treasury finds, upon the Secretary's own initiative or at the request of an appropriate Federal or State law enforcement official, that reasonable grounds exist for concluding that additional recordkeeping and/or reporting requirements are necessary to carry out the purposes of this part . . . the Secretary may issue an order requiring any domestic financial institutions in a geographic area and any other person participating in the type of transaction to file a report. . . .

31 C.F.R. § 103.26(a) (1991).

> "Geographic Area" means any area in one or more States of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the United States Virgin Islands, Guam, the Commonwealth of the Northern Mariana Islands, American Samoa, the Trust Territory of the Pacific Islands, the territories and possessions of the United States, and/or political subdivisions or subdivisions thereof. . . .

31 C.F.R. § 103.26(d)(4) (1991).

and illicit manipulation.[87]

Adding to the arsenal of federal statutory weapons to fight money laundering was the enactment of the Anti-Drug Abuse Act of 1986,[88] the Anti-Drug Abuse Act of 1988[89] and the Crime Control Act of 1990.[90] The 1986 Act contained a provision finally making the laundering of money a crime.[91] Specifically, 31 U.S.C. § 1956 provides for a "financial transactions" offense and a "monetary transportation" offense for the transportation of monetary instruments other than currency. Also, 31 U.S.C. § 1957 specifically prohibits the knowing engagement in transactions consisting of criminally derived assets valued in excess of $10,000. Included under this Subtitle is a provision prohibiting "structured" transactions and a directive to financial regulators to impose regulations requiring their wards to establish and maintain internal mechanisms to ensure compliance.[92]

Title II of the 1986 Act mandates economic sanctions against foreign nations involved in the production or transmission of drugs.[93] Under this section, the President may waive sanctions by certifying to Congress that these nations are cooperating with U.S. narcotics control efforts and are taking adequate steps to eliminate, "to the maximum extent possible," the laundering of drug profits. The President may also waive sanctions if it is in the vital national interest of the United States.[94]

The 1988 Act Amendments enacted several provisions to bolster federal programs for the coordination and cooperation of money laundering mitigation efforts with foreign countries. The Secretary of the Treasury is directed by 31 U.S.C. § 5311 to negotiate with foreign finance ministers toward the establishment of an international currency control agency. Section 5311 also requires that the Secretary negotiate agreements with foreign countries regarding recordkeeping for large U.S. currency transactions and their disclosure to U.S. law enforcement officials.

Penalties for non-compliance with the above provisions are stiff;[95] civil penalties of up to $100,000 or the amount involved in the transaction can be imposed for a single violation, and criminal penalties of up to $500,000 in fines and/or ten years in jail are authorized for willful violations.[96] Banks are more than encouraged to comply.

As is evident, currency transaction recordkeeping and reporting are

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87. *Blanket Reporting, supra* note 8 at 874-880.
88. Anti-Drug Abuse Act of 1986, Pub. L. No. 99-570, 100 Stat. 26 (1986).
89. Anti-Drug Abuse Act of 1988, Pub. L. No. 100-690, 102 Stat. 4181 (1988).
90. Crime Control Act of 1990, Pub. L. No. 101-647, 104 Stat. 4789 (1990).
91. The Money Laundering Control Act of 1986, Pub. L. No. 99-570, § 1352, 100 Stat. 3207-18, 18-21 (1986).
92. *Id.* at §§ 1354, 1359.
93. Anti-Drug Abuse Act of 1986, *supra* note 88, at § 2005.
94. *Id.*
95. *See Blanket Reporting, supra* note 8, at 879-881.
96. *See* 31 U.S.C. §§ 5321, 5322.

the primary focus of U.S. efforts. In October of 1989, the Treasury Department filed an Advance Notice of Proposed Rulemaking to address the problem of money laundering through international payments through wire transfers.[97] Citing authority under the Bank Secrecy Act, 31 U.S.C. §§ 5314 and 5318(a)(2), and the commensurate regulations under 31 C.F.R. § 103, whereby the Secretary "may require reports or records relating to transactions between persons subject to the jurisdiction of the United States and foreign financial agencies," and that domestic financial institutions "maintain appropriate procedures" to ensure compliance with any regulation proscribed, Treasury proposed these regulations to address the continuing problem of money laundering.[98] Under these proposed regulations, domestic financial institutions would be required to keep a record of *each* international transaction over $10,000, including international wire transfers of funds and book transfers of credit.[99] The Department of the Treasury also solicited comments from financial institutions concerning ways in which Treasury could utilize efforts undertaken within the private sector, such as the "know your customer" procedures.[100] On October 15, 1990, the Treasury Department issued a Notice of Proposed Rulemaking[101] setting out its proposals for amending 31 C.F.R. § 103. Included in the proposed Rulemaking are amendments to 31 C.F.R. § 103.25, the foreign financial agencies targeting, and 31 C.F.R. § 103.33, effecting mandatory recordkeeping by financial institutions. The Notice also included proposed amendments to the definitions in the regulations, 31 C.F.R. § 103.11.[102] These proposals would require recordkeeping of, but not the reporting of, electronic funds transfers conducted by a bank.[103] Non-bank purveyors of currency and monetary instruments

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97. *Bank Secrecy Act Regulatory Applications to the Problem of Money Laundering Through International Payments*, 54 FED. REG. 45769 (1989) (to be codified at 31 C.F.R. 103).

98. *Id.* at 45770.

99. *Id.*

100. *Id.* at 45771; *see also Know Your Customer, supra* note 83, at 7. Know your customer policies basically require financial institutions to require complete and thorough identification upon opening account with follow-up procedures for the institution to become familiar with the types of services utilized and potential needs of this account holder. Any deviation from a pattern thus established would be "suspicious," and could be flagged and reported.

101. *Proposed Amendment to the Bank Secrecy Act Regulations Relating to Recordkeeping for Funds Transfers by Banks and Transmittals of Funds by Other Financial Institutions*, 55 Fed. Reg. 41,696 (1990) [hereinafter *Proposed Rulemaking*].

102. *Id.* at 41699.

103. Banks would be required to retain the following information for each funds transfer:

> (1) The name of the originator of the payment order, and the originators account number, if applicable;
>
> (2) unless the originator is a publicly traded corporation, public utility, or government agency, the name of any person on whose behalf the funds transfer was originated, if different from the originator at (1);
>
> (3) the amount of the funds transfer;
>
> (4) the execution date of the funds transfer;

would also be subject to record retention for transmittals or receipts of funds. Non-bank institutions subject to these proposed regulations would include telegraph offices, travel agencies and check cashing companies.[104] If a non-account holder requests a transfer, the bank must verify the name and address of the person originating the transfer and maintain a separate record of the person's name, address, social security number and date of birth.[105] These proposals are designed to standardize the currently inconsistent recordkeeping required under existing regulations.

It is estimated that 40,000 institutions will be required to be in compliance with these proposed regulations.[106] Treasury received over 400 comments from a variety of sources including banks, securities brokers, Western Union, American Express, check cashing services, travel agencies and anyone who might transmit funds by electronic impulse.[107] It is an understatement to say that these proposed regulations are not being received with open arms in the financial community. They have evoked almost unanimous opposition and sparked a flurry of protest regarding the burdens, costs, utility and impact of these rules.[108] According to the Department of the Treasury, most comments noted that the essence of the automated international payments system is the speed with which it moves funds and that any regulation which would impede this efficiency would make United States banks less competitive.[109]

The Bankers Association for Foreign Trade (BAFT) filed one of the most comprehensive comments stating that the proposals fail to meet the required standards of a Reagan Administration executive order requiring federal agencies to measure proposed regulations under two standards: that they be a part of a cohesive, practical and effective strategy and that they should meet a rational cost-benefit analysis.[110] BAFT contends that these regulations will cost financial institutions in excess of $100 million annually for increased compliance and lost revenues and that the pro-

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(5) the payment instructions, if any;

(6) the identity of the beneficiary's bank; and

(7) the name of the beneficiary of the payment order, and the account number if applicable.

Id.

104. *Id.* at 41700.

105. *Id.* at 41701.

106. *Cost, Utility of Wire Transfer Regulation Questioned*, MONEY LAUNDERING ALERT, Feb. 1991, at 6 [hereinafter *Regulation Questioned*].

107. *Id.*

108. *Id.*

109. *Proposed Rulemaking, supra* note 101.

110. *Regulation Questioned, supra* note 106, at 6. CHIPS' comment stressed that the U.S. dollar in recent years has been challenged in its primacy by the yen and the mark. CHIPs maintains that it has kept its position as the primary conduit of foreign wire transfers because the mechanisms for making dollar payments are the most secure and efficient in the world. It emphasized that to jeopardize that situation would not be in the long-term interests of the U.S. because movement by the European Community toward a common currency could pose a significant challenge to the dollar's status. *Id.*

posed regulations would significantly and adversely effect competition and U.S.-based business' ability to compete with foreign competition.[111] It was estimated that the 300 largest U.S. banks would incur start-up and first year implementation expenses of over $160 million dollars.[112]

The American Bankers Association, in its letter of comment to the Department of the Treasury on the proposed Rulemaking summarized its concerns as follows.

> — The proposal, if implemented, would likely be circumvented by money launderers using the funds transfer mechanism by providing erroneous and unverifiable information.
>
> — The costs borne by the banking industry to comply with this proposal would easily exceed $120 million at a time when the banking industry is facing other substantial Bank Secrecy Act related compliance costs and declining profitability.
>
> — Users of the highly efficient large-dollar funds transfer mechanism would face increasing costs and decreased efficiency, thus diminishing the competitiveness of domestic financial institutions, hampering U.S. dollar-denominated trade, and encouraging offshore netting and settlement of U.S. dollar transactions.
>
> — Many of the aspects of the proposal are inconsistent with existing funds transfer conventions and law.
>
> — Money laundering activity represents an extremely small proportion of both the number of transactions and dollar volume conveyed by the transfers. Treasury's confinement of exempted transfers to just those between domestic banks for their own accounts is too limited.[113]

There are other problems with the proposed regulations. One such problem is that there is apparent conflict with long established norms and conventions that have governed party rights and obligations. Article 4A of the Uniform Commercial Code specifies the duties of an "originator's" bank and a "beneficiary's" bank and the time frames for taking certain actions.[114] At a time when the Department of State will be pushing for international adoption of Article 4A as the model national law in the UNCITRAL meetings, it seems inconsistent at best for Treasury to be endorsing efforts which undermine the Code's predictability and integrity.[115]

The Proposed Rulemaking contains a requirement that the originating bank determine from the originator the name of the person or persons "on whose behalf" the person is acting before executing the payment order. Additionally, the rules would require the beneficiary's bank to *with-*

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111. *Id.*
112. *Id.*
113. Corwin letter, *supra* note 24, at 1-2.
114. *See* U.C.C. art. 4A § 207, and comments 1-9.
115. Telephone discussion with Harold S. Burman, *supra* note 40.

hold payment to a non-deposit account holder beneficiary if such information is absent.[116] This proposal directly contradicts the orderly process outlined within Article 4A-207. The confusion, potential liability and commensurate cost of the delays inherent in this proposal are staggering to imagine.

Another difficulty with the Proposed Rulemaking is that a particular monetary threshold triggering compliance is not provided. Regardless of whether the amount is $1.00, $10.00, $100 or $1,000,000 dollars, financial institutions will be required to record the mandatory data. While this provision appears to be aimed at the prevention of "structuring" laundered money in any size increment, it will place an inordinate burden on institutions to keep detailed data on far more transactions than presently recorded. This makes little sense, since it is hardly plausible that a "smurf" would be laundering millions in increments of one hundred dollars.

The Proposed Rulemaking has yet to be issued in its final form. It was predicted that the final form might have materialized as early as late January, 1992;[117] however, President Bush's State of the Union moratorium for ninety days on the enactment of federal regulations has furthered delayed its arrival. Previously, however, such release dates have been suggested and not been met for many months. In fact, the delay now of almost two years since the Advance Notice of Proposed Rulemaking on this issue has frustrated Congress to the point of introducing mandatory release dates.[118] The issue has been further complicated by the Treasury Department's release of yet additional proposals set forth under the Bank Secrecy Act to combat money laundering. These proposals govern the daily aggregation of cash transactions by or on behalf of an accountholder and magnetic filing of currency transaction reports by certain financial institutions.[119]

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116. *See Proposed Rulemaking, supra* note 83.

117. Telephone discussion with Pamela Johnson, Director of Compliance, Office of Financial Enforcement, Department of the Treasury, December 26, 1991. This timeframe was confirmed by John Byrne, Chief Counsel, American Bankers Association, and Lamar Smith, Minority Chief of Staff, Senate Committee on Banking Housing and Urban Affairs.

118. *See Treasury May Have FED for Partner on Money Laundering Rule, Attorney Says*, BNA'S BANKING REPORT, Aug. 19, 1991 at 290 (S. 543 and H.R. 26, mandating Treasury to work with the Federal Reserve to issue joint rules on money laundering by a specified date). Note that provisions on money laundering were stripped from the ultimate version of the banking bill prior to final passage during the last session of Congress. *Compare* H.R. 26 *with* the amended S. 543, P.L. 101-242, the final enacted measure. Also, as of the final edit of this article, there were discussions on renewing indefinitely the current moratorium on federal regulations implementation.

119. *See* Mandatory Aggregation of Currency Transactions for Certain Financial Institutions and Mandatory Magnetic Reporting of Currency Transaction Reports, 55 Fed. Reg. 36663 (1990).

V. ALTERNATIVES TO RECORDKEEPING

Present regulations requiring currency transaction reporting produce a quantity of records so vast that the government has neither the resources or the inclination to utilize the information they currently obtain.[120] Even the Attorney General of the United States expressed his concern over the vast expansion of reports being filed with the government. In a speech before the New York convention of the American Bankers Association in October of 1989, Attorney General Richard Thornburgh stated that because of the tremendous increase in the number of reports filed, "In equal candor, I must admit that these millions are now part of the problem as well as the solution."[121] The Treasury Department seems to have taken the comments of the former Attorney General to heart and are now requiring that the vast and costly mountains of information that will be generated not be reported to Treasury, but be maintained within the institutions themselves. The primary problem with broadly based reporting and recordkeeping requirements is that huge amounts of information are generated and little of it is utilized. As has been stated, the vast majority of wire transfers are conducted for legitimate purposes. Even the Federal Reserve Board, an organization with far superior experience and expertise in regulating large-volume wire transfers by banks than the Treasury Department,[122] has expressed concern about the high costs that would be imposed on banks and their customers who send and receive funds transfers. Additionally, the Board expressed its concern that the proposed regulations could seriously impede the efficiency of the nation's large-dollar electronic funds transfer systems.[123]

The Federal Reserve included with its comment letter to the Treasury a staff prepared analysis of the Proposed Rulemaking setting forth its concerns and proposals for alternatives, which states in part:

> If adopted as proposed, the amendment would impose very substantial costs on banks handling funds transfers; however, Treasury has not demonstrated that the particular elements of the proposal that are likely to impose the greatest costs on banks will yield commensurate benefits in terms of improved ability to investigate money laundering activities or prosecute criminals. In particular, Treasury has not demonstrated, as required by the Bank Secrecy Act under 31 U.S.C. Sec. 1952, that these recordkeeping requirements "have a high

120. Jeanne Iida, *IRS' Kirby Braces to Fight Drugs With Electronic Data*, THE AMERICAN BANKER, October 19, 1990 at 2; *see also Control Efforts*, *supra* note 6, at 149 (testimony of Donald Sergeant, President, Independent Bankers Association of America).

121. *See Control Efforts*, *supra* note 6.

122. Letter from William Wiles, Secretary of the Board of Governors of the Federal Reserve System to Peter K. Nunez, Assistant Secretary, Department of the Treasury, January 25, 1991 (comment letter) [hereinafter Wiles letter]; *see also Treasury May have FED for a Partner on Money Laundering Rule, Attorney Says*, BNA's BANKING REPORT, Aug. 19, 1991, at 290.

123. Wiles Letter, *supra* note 122.

> degree of usefulness in criminal, tax or regulatory investigations and proceedings." The Board believes that simplified and less costly recordkeeping requirements could be established that would provide adequate information on funds transfers for those law enforcement purposes for which the records will most likely be used. If subsequent experience demonstrated that these records were inadequate and that additional requirements are needed to effectively serve law enforcement purposes, such requirements could be added at a later date.[124]

The letter goes on to suggest that wire transfer recordkeeping could be effective to: *detect* financial crimes, such as money laundering, or the underlying illegal activity, such as drug trafficking; *investigate* such activity by linking parties in a chain of transfer of illicit proceeds; or *trace* the proceeds of illegal activity for potential seizure.[125] However, the Board insists that there are less burdensome, less complex and less costly alternatives. The Board adopts three principles prior to providing its suggestions. First, because timely processing is an essential characteristic of the nations' large-volume funds transfer system, any requirement should not result in the delay of the execution of any payment orders. Second, any mandatory recordkeeping should not require greater manual intervention than is present in today's highly automated payments mechanism. Finally, the rule should not require banks to obtain information not generally obtainable under current regulations unless the costs to obtain the additional information are outweighed by the benefits to law enforcement in detecting and investigating money laundering activity.[126] Generally, the Board suggests that only the minimum necessary information, already collected by the originator's bank, be sent with the payment order to the beneficiary bank for retention. Additionally, the Board recommends that all bank-to-bank transfers and transfers of less than $10,000 (like the currency transaction reporting) be exempted from any requirements.[127]

Imposing a monetary threshold on the recording requirement alone could reduce much of the useless information that would be collected under Treasury's current proposals. It has been suggested that exempting amounts under $1000 would eliminate the need for reporting the one-time consumer transactions or emergency transmissions of funds to stranded

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124. *Id.*

125. *Id.*

126. *Id.*

127. *Id. See also* European Update, *supra* note 70 (discussing an EC directive on the prevention of use of the financial system for the purpose of money laundering):

> The principle of the Directive is that institutions are in the best position to judge whether laundering is taking place or not and builds on agreements already incorporated in the 1988 UN Vienna Convention against drug trafficking . . . . This system was chosen above the U.S. system which requires all transactions above US 10,000 dollars to be automatically reported to the authorities, and the US system was considered too expensive as it does not differentiate between normal and suspect transactions.

For a more in depth review of current anti-money laundering activities in Europe, see *European Initiatives, supra* note 8.

travelers.[128]

Broader implementation of "know your customer" policies could assist in the government's enforcement efforts. Although solicited for comment in the Advanced Notice, Treasury failed to integrate such policy into its Proposed Rules. Under "know your customer" policies, banks make reasonable efforts to become familiar with its deposit and loan customers, and makes a reasonable assessment of the types of use and reasons for a customer's use of ancillary services such as wire transfers, cashiers checks, money orders, etc. Banks should then decline to do business with individuals failing to provide sufficient information and businesses which refuse to provide proper background information and credentials.[129] A concerted effort toward meeting these basic principles allows the institution to assist in identifying suspicious deposit and transaction account activities. For instance, a neighborhood delicatessen typically has no business need to open multiple accounts that receive volumes of cash in increments of less than $10,000 dollars and which are periodically aggregated and wired to a numbered account in Luxembourg. Such discrepancies would be apparent to the institution, and information regarding that particular suspicious account would then be reported to enforcement officials. The great majority of transfers undertaken for legitimate and valid business and personal reasons would not need to be reported.

VI. CONCLUSION

The Treasury Department should heed industry warnings, concerns and admonitions contained in the comment letters on the Proposed Rulemaking on wire transfer recordkeeping. With the domestic banking industry currently experiencing economic pressure from several different fronts, an additional layer of mandatory recordkeeping could prove more costly than the compliance figures indicate. Although it professes a laudable objective, if this proposal is approved in the form proposed, serious adverse consequences may result. Not only is the Treasury Department out of sync with its fellow domestic bank regulators in the Federal Reserve, it is out of sync with the rest of the financial world. It is imperative that the Treasury Department reconsider the cost and benefit of mandating such far-reaching recordkeeping requirements, especially when there exist less intrusive avenues toward combatting the ills of money laundering. This worthy battle must not detract from the efficiencies and competitive advantages currently enjoyed by this nations' electronic funds transfer international payments system. This proposal should not survive the moratorium on the release of federal regulations imposed by President Bush in his State of the Union message.

Gerard Wyrsch

128. *See Blanket Reporting, supra* note 8, at 890.
129. *See Know Your Customer, supra* note 83, at 8.

The Gentle Revolution: German Unification in Retrospect

I. Introduction

"The entire German people remains called upon to complete the unity and freedom of Germany in free self-determination."[1] This reunification commandment or *Wiedervereinigungsgebot* operated in the Federal Republic of Germany's legal and political system during the Federal Republic's entire existence. On October 3, 1991, after nearly forty-five years of partition and separate political, economic and ideological development, the German people acheived the goal: unity created in self-determination. They fulfilled the commandment's second component, freedom, as well — at least to the extent that the beneficiaries of a social-market system understand the term. Just a little over a year passed between the beginning of grassroots opposition movements against the East German regime, including the spectacular opening of the Berlin Wall on November 9, 1989, until the December 3, 1990, completion of the merger of the two states. East German leadership, having seen only Walter Ulbricht and Erich Honecker as heads of state during its entire existence, changed hands three times during the transitional period before it finally became part of the Federal Republic.

This article will examine why the reunification, impossible to imagine only six years ago, took such a rapid pace, thereby subjecting Easterners and Westerners to the shock treatment of economic and political unity without an interim period of acclimatization. In addition, this article will address what alternatives existed to the swift unification process.

II. Historical Background

A. *From 1949 to 1989*

In 1949, four years after the conclusion of World War II, the Allied Forces agreed to the creation of two German states.[2] The Western Allies and the Soviet Union took control of the defeated Germany immediately after the War. The partition of Germany was the result of the irreconcilable differences the allies encountered in the exercise of that control.[3]

After the partition, the Western state named itself the Federal Re-

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1. GRUNDGESETZ [GG] [federal constitution], preamble (F.R.G.) [hereinafter GG]; *see also*, Gregory v.S. McCurdy, Note, *German Reunification: Historical and Legal Roots of Germany's Rapid Progress Towards Unity*, 22 N.Y.U. J. INT'L L. & POL. 253, 259 (1990).
2. Peter E. Quint, *The Constitutional Law of German Unification*, 50 MD. L. REV. 475, 629 (1991).
3. *Id.* at 479-480.

public of Germany (*Bundesrepublic Deutschland*, F.R.G.), and organized its public affairs in accordance with a quasi-constitutional political document called the Basic Law (*Grundgesetz*). The very name Basic Law, chosen instead of Constitution (*Verfassung*), evidences the fact that the F.R.G., from its inception, regarded itself as a temporary political entity. The Western state's prevalent commitment to eventual unification is manifest in a number of constitutional provisions. First, the Basic Law's language provided for the possibility of constitutional change when the remaining portions of post-war German territory acceded to the F.R.G.[4] Second, Bonn, a historically unknown and insignificant city, became the seat of the new state, rather than Berlin, Munich, or Nuremberg, which are traditional German capital cities.[5] Third, the Basic Law granted citizenship to all persons of German origin and thereby included all citizens of the East German state. Accordingly, all residents from the East who were exiled to or fled to the West between 1949 and 1990 enjoyed the same political and economic rights as F.R.G. citizens.[6] Finally, the *Bundesverfassungsgericht*, the high court charged with interpreting the Basic Law, consistently held that the pre-war German Reich never ceased to exist.[7] F.R.G.'s Western allies also supported the principle of eventual unification throughout the decades of partition.[8]

The new Eastern state took the name German Democratic Republic (*Deutsche Demokratische Republik*, G.D.R.) and adopted its own constitution in 1949. This constitution was originally intended to apply to all of Germany.[9] Initially, the G.D.R. and the Soviet Union were not hostile to the possibility of future reunification. However, once the F.R.G. joined NATO, the Eastern position changed, viewing the two German states as separate entities. This position was codified in a revised version of the G.D.R. constitution adopted in 1968 and amended in 1974.[10] The 1968 and 1974 versions included basic principles of democratic centralism to be implemented by the Communist Party: a planned economy, nationalized property, and affirmative social welfare rights.[11] In contrast with the F.R.G. Basic Law, the G.D.R. constitution mentioned neither the possibility nor the desirability of reunification.[12]

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4. GG art. 23 (F.R.G.) states:

For the time being, this Basic Law shall apply in the territory of the Laender [individual states] Baden, Bavaria, Bremen, Greater Berlin, Hamburg, Hesse, Lower Saxony, North-Rhine-Westphalia, Rhineland-Pfalz, Schleswig-Holstein, Wuerttemberg-Baden, and Wuerttemberg-Hohenzollern. It shall be put into force for other parts of Germany on their accession.

5. McCurdy, *supra* note 1, at 257.
6. *Id.* at 259-260.
7. Quint, *supra* note 2, at 481.
8. *Id.* at 480.
9. *Id.* at 483.
10. Quint, *supra* note 2, at 483.
11. *Id.* at 488-490.
12. *See* CONSTITUTION OF THE G.D.R. [Verf. DDR] (1974).

Due to ideological differences between the new German states and their respective controlling superpowers, relations deteriorated during the period of 1949-1972. For example, West Germany quickly became economically superior to East Germany. Political and individual freedoms enjoyed by the Western Germans exceeded those available in the East. As a result, large numbers of G.D.R. citizens relocated to West Germany. Because of the exodus to the West, the East German government erected the Berlin Wall in August of 1961, thereby greatly aggravating the hostilities between the two countries.[13] Many people died from guards firing at them or land mines exploding while they attempted to escape from the East.[14]

In 1972, the Social Democratic Government, led by Chancellor Willy Brandt, initiated an inter-German treaty with the East German government. This Fundamental Treaty (*Grundlagenvertrag*) intended to address and succeeded in solving immediate problems such as family reunions and traffic to and from Berlin.[15] The Fundamental Treaty recognized each German state's sovereign power, independence and equality, and provided for separate international representation. By meeting the reality of two separate political entities, the treaty relieved some public and individual hardships.[16]

Although this treaty may be viewed as an abandonment of the once strong commitment to unification, the language of the Basic Treaty reflected a faint optimism regarding the possibility of future reunification. Recognition of two capitals was avoided by reference to "seats of government," and the term "embassy" was replaced by the word "government mission."[17] In essence, the treaty did not purport to be a permanent solution but merely an instrument of the East-West detente that occurred during the 1970s.

Even though the unification issue has been of significant political importance to the West Germans throughout the F.R.G.'s existence, the degree of importance varied according to political party perspective. The conservative parties, *Christlich Demokratische Union* (CDU) and *Christlich Soziale Union* (CSU), considered the question of German unity to be the highest priority;[18] consequently, they strongly disapproved of any attempt to legitimize the sovereign existence of the G.D.R.[19] The

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13. *See also Die Mauer — Symbol fuer die Teilung Deutschlands*, NEUE PRESSE, Nov. 11, 1989, at 5.

14. *Id.* at 9.

15. McCurdy, *supra* note 1, at 267. The city of Berlin was completely surrounded by G.D.R. territory.

16. *See* McCurdy, *supra* note 1, at 267-69.

17. *Id.* at 268-269.

18. *Id.* at 267.

19. In Bavaria, the largest and eastern-most state governed by CSU, school children were taught to refer to East Germany by its abbreviated name so as to avoid pronouncing the term "Democratic," contained in the full name. On the other hand, they were to refer to their own state by its full name, rather than its acronym, to show respect. This is from the

Liberal/Social-Democratic coalition, which governed during the 1970s, attributed high importance to the national question. However, they approached the subject with the political realism necessary for easing the ideological tensions that arose during the Cold War.[20]

For the Greens, a relatively new party that came into existence in the late 1970s and gained seats in the parliament (*Bundestag*) in 1980, the unification issue was of low priority in relation to issues of more global, ecological or social nature. Suspicions traditionally held by twentieth-century German leftists towards nationalism explain the Green Party's disinterest in the unification question.[21]

B. *From 1989 to 1990*

In the summer of 1989, when Hungary opened its borders, thousands of Germans — mostly young adults — crossed into Austria, for ultimate relocation into West Germany. They also sought refuge in West German embassies in Prague, Budapest, and Warsaw.[22]

Within East Germany, political opposition groups were formed, and popular demonstrations took place in the city of Leipzig.[23] These popular uprisings were spared the Soviet/G.D.R. sponsored military crack-downs encountered in the past. In fact, Soviet leader Michail Gorbachev warned G.D.R.'s Honecker that he would not support any kind of intervention.[24] Shortly thereafter, Erich Honecker[25] resigned as General Secretary of the Central Committee of the Communist Party (SED) and was replaced by Egon Krenz, a long-time Communist Party member.[26] On November 9, 1989, the G.D.R. government opened the Berlin Wall, a sudden, unexpected, and highly celebrated event that marked the beginning of rapid political changes, culminating in the unification of the two states less than a year later.[27] After the gates opened, masses of East Germans flooded across the border for both temporary shopping visits and permanent relocation. Initially, attempts were made to salvage the G.D.R. state by implementing immediate and fundamental reforms. Egon Krenz, distrusted by the people because of his standing within the Communist Party, was quickly replaced by reformer Hans Modrow, one of the very few officials of the SED who held the trust of the people. He replaced the parliamentary governing body (*Volkskammer*) and initiated democratic

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author's personal experience.

20. McCurdy, *supra* note 1, at 270.
21. *Id.* at 273.
22. Quint, *supra* note 2, at 485.
23. *Id.*
24. *Id.*
25. In 1991, Honecker fled and is currently hiding in the Russian embassy in Chile. Russia officially requested him to be expelled from Santiago, and Germany wants his return so he can stand trial for murder and related charges. NEUE PRESSE, March 7, 1992, at 1.
26. McCurdy, *supra* note 1, at 286. *See also* Quint, *supra* note 2, at 630; *Kohl trifft Krenz*, NEUE PRESSE Nov. 13, 1989, at 3.
27. *Die Berliner Mauer bekommt Locher*, NEUE PRESSE, Nov. 11, 1989, at 1.

elections, by means of which the last G.D.R. leader, Lothar de Mazière, took leadership.[28] Central portions of the G.D.R. constitution were revised and changed.[29] A committee of East and West German academics met regularly to draft a proposal for a new G.D.R. constitution, based on the belief that the G.D.R. would continue in existence for at least an interim period, and possibly permanently as a reformed state.[30]

Subsequent changes in inter-German relations, however, proved to be steps toward unification rather than attempts to build an interim East German state. For example, the currency reform that took effect on July 1, 1990, replaced the non-convertible, low-valued East German Mark with the stronger West German currency.[31] The previously abolished five states (*Laender*) were reconstituted: Berlin-Brandenburg, Mecklenburg-Vorpommern, Sachsen-Anhalt, Sachsen, and Thueringen.[32] Finally, on August 31, 1990, the unification treaty was signed,[33] followed by the Allies suspending their reserved rights.[34] On October 3, 1990, the newly revived East German states acceded to the F.R.G.[35] Elections for the *Laender* parliaments and for the first all-German *Bundestag* followed within the same year.[36]

III. MOTIVATIONS FOR UNIFICATION ANALYZED

A. *The West*

The West German government, led by Chancellor Helmut Kohl of the CDU, began working towards unification as soon as the opening of the borders allowed for speculation about the disintegration of the G.D.R.. This early focus on unification was evidenced by Kohl's ten-point plan, a 1989 proposal outlining the steps by which to build a united Germany.[37] Kohl's drive for a rapid merger was due in part to the F.R.G.'s constitutional framework, the historical commitment of the Chancellor's party, and to the heightened political importance the issue had gained among the West German people.[38] Working for unity was the most important campaign issue for the 1990 *Bundestag* election.[39] The highly emotional aftermath of the fall of the Berlin Wall and the opening of all East Ger-

28. Quint, *supra* note 2, at 630.
29. *See generally id.* at 496-506.
30. *Id.* at 493.
31. *Id.* at 516.
32. *See generally id.* at 524-530.
33. *Id.* at 630.
34. The Allies retained certain rights following World War II, including the rights of occupation and supreme authority with respect to Germany, short of annexation. Quint, *supra* note 2, at 589 et seq.
35. Judith Reicherzer, *Der letzte Schnitt*, DIE ZEIT, Nov. 29, 1991, at 10.
36. Quint, *supra* note 2, at 630.
37. *Id.* at 486.
38. McCurdy, *supra* note 1, at 271-72.
39. *Id.* at 272.

man borders brought the unification issue to the forefront of each West German citizen's mind.[40] Accordingly, unification was a much more desirable goal politically than any interim solution for the rapidly disintegrating East German state.

The initial euphoria soon cooled. The West German people grew annoyed with the sudden and continued congestion brought about by the floods of Eastern visitors,[41] and frustrated by the consumer good shortages caused by the extraordinarily high demand from the East.[42] Westerners became more realistic about the consequences of reunification. The high costs of integrating a state as backwards as the G.D.R. and making it productive again were now unenthusiastically anticipated by the tax-paying citizens of West Germany. The government had to move forward rapidly with the process of unification in order to maximize the remaining public interest and support.[43]

B. *The East*

After the Wall's fall, Egon Krenz believed that, as a result of legalized travel, the economically devastating exodus of educated and skilled workers would decline.[44] When instead the outflow of workers increased after the borders opened, the government realized that more fundamental changes were needed. This explains the rapid changes in leadership before unification, from Egon Krenz to Hans Modrow to Lothar De Mazière. Initially, Modrow had planned to continue the G.D.R.'s existence through a series of treaties with the West, a form of economic unity that fell short of complete merger.[45] Ultimately, the democratically elected leaders Modrow and De Mazière recognized what had long been believed in the West: that the East German state derived justification for its existence solely from the Communist bloc. The fall of the Soviet Empire, well under way at that time, was bound to result in the disappearance of the G.D.R. as a separate state.[46] Consequently, the initial plans for alternative forms of integration with the West were abandoned, and the Eastern leaders entered into agreements with the West and changed their constitution to enable the 1990 merger with the F.R.G..[47]

The majority of the East German people originally opposed unification.[48] While taking advantage of the newly available freedom of travel,

40. NEUE PRESSE, Nov. 13, 1989, at 33-38.

41. *See Coburg will City sperren*, NEUE PRESSE, Nov. 15, 1989, at 1.

42. Interview with Robert Jeffares, Department Supervisor for Siemens-Nixdorf AG, in Coburg, West Germany (Dec. 1989).

43. *See* Jochen Thies, *Digesting Unification*, EUR. AFF., Oct./Nov. 1991, at 14-15.

44. McCurdy, *supra* note 1, at 286-287.

45. *Id.* at 290.

46. *Id.* at 255. With the râison d'être of the G.D.R. so closely tied to the ideology of the Soviet empire, no form of East Germany could have continued to exist on its own. Accordingly, the collapse of the Soviet Union necessitated German unification.

47. *Id.* at 290-293.

48. *Id.* at 284.

uncensored media, and plentiful consumer goods, they did not immediately embrace the idea of a political merger with the West. Forty years of indoctrination about the virtues of the Socialist system and the evils of the free market economy produced suspicion. Citizens develop significant pride in their state over time, irrespective of the hardships and deprivations the system has imposed on them.[49] Despite the comparative superiority of the Western state, many conditions in the F.R.G. elicited criticism from both Eastern and Western social justice activists, particularly conditions such as environmental exploitation, homelessness, unemployment, and the imperfections of the West German social welfare system.[50] Additionally, the resentment and arrogance exhibited by Westerners towards their Eastern cousins chilled the initial euphoria.[51]

Despite these negative factors, the East Germans ultimately came to favor expeditious unification. The reasons for the change are manifold. Free and easy travel to the West exposed Easterners to democracy and the social market economy of the West.[52] Taking advantage of the material consumer bounty was easy in the beginning, as every Easterner who arrived in the West was entitled to receive a certain amount of "Welcome Money" (*Begruessungsgeld*) from the local governments of their destination.[53] Businesses offered special deals to Easterners in the wake of the euphoria.[54] A freed media exposed the hypocritical and exploitative lifestyle of the East German leadership to an outraged people, further undermining the legitimacy of the socialist regime.[55] Political freedom allowed Western political parties and their leaders to preach unification in the East. Finally, massive economic aid from the West German government and widespread investment by West German businesses helped sway the Easterners to ultimately favor rapid political and economic unification.[56]

IV. ECONOMIC AND POLITICAL CONSEQUENCES OF UNIFICATION

A. *The Present Reality*

Although the historical goal of unification has finally been achieved, the West inherited an economic nightmare, becoming fully responsible for the East's neglected infrastructure and a bankrupt economy. Factories, roads, power plants, buildings, and technology were mismanaged, deterio-

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49. *See id.* at 284.

50. *Bahro will zurueck in DDR*, NEUE PRESSE, Nov. 15, 1989, at 3. *See Immer mehr Obdachlose*, NEUE PRESSE, Nov. 15, 1989, at 2; *see also Notstand in den Kindergaerten*, NEUE PRESSE, Nov. 15, 1989, at 18.

51. *See Doppelkassierer*, NEUE PRESSE, Nov. 15, 1989, at 17.

52. McCurdy, *supra* note 1, at 285.

53. *Begruessungsgeld aufgestockt*, NEUE PRESSE, Nov. 16, 1989, at 1.

54. *Kultur zum Sondertarif*, NEUE PRESSE, Nov. 15, 1989, at 1; *see also Die sanfte Invasion*, NEUE PRESSE, Nov. 17, 1989, at 4.

55. McCurdy, *supra* note 1, at 288.

56. *Id.* at 293-295.

rating, and decades behind the West.[57] Even though the labor force is skilled and well educated, the Easterners' work ethic greatly differs from that of the West Germans'.[58] Core East German industries, historically supported by subsidies and artificial price controls, are no longer profitable nor maintainable in a market economy. For example, nearly the entire East German textile industry must be shut down because the low product quality and high labor costs cannot compete with imports from South East Asia. Although wages in East Germany are far lower than wages in the West, they are still higher than wages in the textile-exporting Asian countries. Attempts to upgrade portions of the industry to manufacture high-quality clothes failed because the sewing machine operators were unable to handle the high-quality textile materials as quickly as they handled low-grade fabrics.[59]

The *Treuhandanstalt*, a recently created government agency acting as a public trustee, is attempting to sell East German production facilities to Western owners. However, Easterners regard the agency with increasing suspicion. The East-CDU favors a policy of preserving independent, locally-owned businesses rather than the *Treuhandanstalt's* policy of auctioning off Eastern industries to outsiders.[60] The East German workers feel that the *Treuhandanstalt* — created in Bonn by Western politicians — is more interested in high sales than in preserving work places.[61]

The East still struggles under widespread unemployment, which places a tremendous burden on public finances. Many Easterners actually experienced a decline in their standard of living due to increasing prices and decreasing income.[62]

The West struggles also. Revitalization of the East will cost more than originally anticipated. Taxes have already increased and may rise even more. Many hard-working and tax-paying Westerners feel resentment towards the perceived lack of work ethic on the part of the Easterners.[63] Economic indicators forecast a possible recession.[64] At the same

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57. *See generally* Thies, *supra* note 43, at 14-15 (explaining the overall economic conditions existing in East Germany).

58. Interview with Ingo Bechmann, college student and part-time construction worker, in Coburg, West Germany (December 1989). The then twenty-year-old West German Mr. Bechmann told of an incident where a crew of newly hired construction workers from the East quit working at approximately eleven o'clock in the morning. When questioned by their superior, they answered that the expected delivery of supplies had not yet arrived; from that they concluded that it would not arrive that same or even the next day. When asked why they didn't complete other tasks until the delivery arrived, they answered that nobody had told them to do so. This attitude reflects the workers' adaptation to working conditions where needed supplies could not be relied on, and individual efforts were not rewarded.

59. Reicherzer, supra note 35.

60. Peter Christ, *Bonn greift ein*, DIE ZEIT, Dec. 27, 1991, at 10.

61. Marlies Menge, *Gute Lage als Verhaengnis*, DIE ZEIT, Dec. 27, 1991, at 22.

62. Peter Christ, *Immer Aerger mit den Preisen*, DIE ZEIT, Nov. 8, 1991, at 10.

63. *See generally* Thies, *supra* note 43, at 14-15 (explaining the sentiments felt by many East and West Germans since unification).

time, politicians sympathize with the economic plight of the Easterners: "They didn't go into the streets in the fall of 1989 only to be thrown out into the streets in the fall of 1991!"[65]

Unification produced another problem: an increase of right-wing extremism in both states, but particularly in the East. The rise of Skinhead and Neo-Nazi groups in the East may be a temporary reaction to the disappearance of political uniformity and censorship. Other probable reasons include the psychological effects of fundamental political change and economic depression. The self-perceived underdogs vent their frustrations and fear of future uncertainties by directing violence against those who are even worse off: political refugees with dark skin color, foreign accents, and no place of their own. Ordinary Easterners, observing this drift of ideological violence to the other extreme, feel that law enforcement authorities are appallingly passive in their task of controlling such excesses.[66]

One Wall has been torn down, but because of the economic and psychological differences between the East and the West, a second wall remains. It is a psychological wall, built not by bricks and mortar, but by forty-five years of separate economies, ideologies, and public goals, and vast differences in the means available for private individuals to achieve their personal goals.[67]

B. *Unrealized Alternatives*

Analyzing the current changes in Germany, one questions whether a different approach to unification would have been more sensible. The benefits of a fast unification are identifiable. Reuniting quickly creates certainty; both domestically and internationally. Any delay in the process would have continued the drain of the work force from the East into the better-paying West. The political procedure of unification was a condition precedent to the substantive task of economical and cultural re-approachment and accommodation. Additionally, the German merger provides a framework for other European states to follow.

However, one should consider the advantages of a slower speed toward unification. If the F.R.G. would have evaluated and planned the task of economic upgrading, the people subject to the changes would have had the opportunity to readjust their skills and their economic, political, and social outlook. The labor drain would have continued without unification; however, the drain goes on even after unification due to the higher wages prevailing in the West.[68] A slower pace would have soothed some of

64. *Die Zeichen stehen auf Sturm*, DIE ZEIT, Jan. 10, 1992, at 9.

65. *Zitat des Jahres: Brandenburg Ministerpraesident Manfred Stolpe*, DIE ZEIT, Jan. 3, 1992, at 2.

66. Christ, *supra* note 62.

67. Thies, *supra* note 43, at 15.

68. Reicherzer, *supra* note 35.

the present difficulties.[69]

One should also consider the unrealized advantages of an alternative to the process as a whole. Rudolf Bahro proposed the co-existence of the two German states in close cooperation.[70] The G.D.R. Roundtable seriously considered this option and developed a supporting document.[71]

The Roundtable envisioned the constitution for the new G.D.R. to contain provisions securing a full range of liberal defensive rights and affirmative social welfare rights, including rights to shelter, medical care, and employment; a new system of property rights incorporating both private and publicly owned property; an independent judiciary; a federation consisting of the re-created *Laender* and a central parliamentary government; and a mechanism allowing for popular votes in the parliament.[72] These intellectuals viewed the decline of the G.D.R. as an opportunity for more than a mere merger into an already existing system. They believed a chance existed for extracting the positive aspects of the G.D.R. — albeit existing largely in theory — and those of the F.R.G., and incorporating them into a new state, one with a system of democracy, affirmative entitlements and political rights.

The co-existing states may have provided an alternative to the traditional East-West dichotomy. Unfortunately, a complete renewal from an environmentally, politically and socially mismanaged state into the ideal opposite was too unrealistic to implement. The ingrained traditions produced by the G.D.R.'s communist regime fatally handicapped the possibility of such a metamorphosis. The lack of leadership and hard cash made certain this proposal's impossibility.[73]

V. THE NEXT FORTY-FIVE YEARS AND BEYOND

A swift political unification process cannot substitute for the labors and pains necessary to economically and psychologically integrate two societies. Economically, the work has just begun. The *Treuhandanstalt's* mission of reorganizing production facilities into profitable businesses and soliciting national and international investment is far from complete. Solutions for the persisting high unemployment rates must be developed and implemented. The gap in living standards needs to be equalized to avoid a permanent division of the nation into Haves and Have-Nots. This latter issue demands particular attention because of the Basic Law's mandate for a social market economy. Finally, environmental clean-up must become and remain a priority.

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69. *See generally* Thies, *supra* note 43, at 15 (describing the conflicting sentiments about unification held by East and West Germans).

70. *Bahro will zurueck in DDR*, *supra* note 50. (Rudolf Bahro was a prominent East-German politician who had been expelled from the G.D.R.).

71. *See* discussion *supra* part IIB.

72. Quint, *supra* note 2, at 494.

73. McCurdy, *supra* note 1, at 292.

These economic tasks seem most urgent and overwhelming in light of the tremendous volume of human resources lost to unemployment. Taking into account the involuntary part-timers, early retired, and those participating in retraining programs, the true unemployment rate in the East approaches thirty-eight percent.[74] The overall unemployment numbers are predicted to remain high, which is the natural consequence of the fast-paced reunification: "It is impossible to radically restructure an economy and increase the value of a currency by 300% overnight, without experiencing a collapse of the labor market. The decision for a fast change was also the decision for a massive loss of jobs."[75]

As the process of unification continues, some regions in the East are experiencing significant economic recovery with prospects for labor shortages in the near future.[76] An economic turn-around for the East is generally expected to occur perhaps as soon as this year.[77] The economic challenges are being met and are likely to resolve themselves in the near future.

In the long run, however, further-reaching problems are likely to challenge the German people. The enormous legal, ethical, and psychological dilemmas created by the East's dictatorial past must be confronted and resolved. These dilemmas include: claims of property owners who were expropriated by the G.D.R. and who now have to compete with subsequently created interests of G.D.R. citizens; other problems arising from the question of the legitimacy of judicial decisions that sent political dissidents to prison; and the accountability of those who planted land mines and ordered torture and executions. The German term for the process is *Vergangenheitsbewaeltigung*: facing and mastering one's past. The expression describes Germany's manner of confronting its Nazi past; now it also characterizes their involvement with the Communist past. Unlike the Nazi memory, a national guilt shared by the entire German people, this new awareness of political wrongdoing, decades of human rights violations, and prostitution by the judicial and administrative systems splits the German people in half. The Westerners accuse the Easterners of murdering, imprisoning, and informing on innocent citizens. The opening of Stasi documents reveals much wrongdoing that has occurred over the G.D.R.'s existence: children spying on parents, neighbors turning in neighbors, Stasi officials hunting down their own rank and file.[78] Former low-ranking, order-taking border patrols are now standing trial and facing punishment for homicide and human rights violations to the same extent

74. Birgit Breuel, *A Social Market Economy Cannot Be Introduced Overnight*, EUR. AFF., Dec. 1991, at 28.

75. Dirk Kurbjuweit, *Jeder Dritte Ohne Arbeit*, DIE ZEIT, Feb. 14, 1992, at 10.

76. Peter Christ, *Der Osten Schreibt Rot*, DIE ZEIT, Mar. 6, 1992, at 7.

77. *Id.*

78. *See* Christian Wernicke, *Vorgang Auf!*, DIE ZEIT, Mar. 13, 1992, at 11; Joachim Nawrocki, *Vor einem Berg des Unrechtes*, DIE ZEIT, Feb. 28, 1992, at 5.

as high-ranking officials who issued the deadly orders.[79] They, having acted under color of East German law, have to answer for their past under West German law before West German courts.

Judicial determination of guilt poses moral and ethical dilemmas. The G.D.R. constitution guaranteed freedom of speech and association, and G.D.R. criminal law prohibited murder, manslaughter, torture, extortion, battery and kidnapping, just like the F.R.G.'s constitution and statutes.[80] However, the G.D.R. was governed not by the rule of law but by dictatorship. Once again Germany faces the ethical question of prosecuting not only those who created an unjust system but also those who lived by the system's rule:

> Only if the investigation proceeds systematically . . . will we be able to penetrate through individual cases to the structure of responsibility. Then we will reach the tip of the hierarchy. Whoever planted the bug into the private apartment is really irrelevant. Responsible are those who created the system.[81]

Realistically, many West Germans will have difficulty differentiating between those who ordered the murders and those who carried them out. The Westerners' self-righteous engagement in witch hunts results, for many Easterners, in ruinous publicity or prohibitions on professional engagement.[82] This antagonism may be a result of the Westerners experiencing unification as initiated by and imposed from the government above,[83] while having to bear the financial burdens, especially following the levy of the new "Solidarity Assessment" tax.[84]

How Easterners and Westerners deal with the dynamics of public sentiment will be crucially important to the success or failure of the new nation. Gaps of such a nature take longer to bridge than solving economic problems or cleaning up severe environmental damage. The "Wall in the Head" may stand strong for a long time to come.

VI. CONCLUSION

For the West, the primary driving forces leading to swift unification were historical and cultural commitment, while economic emergency and political disintegration served as primary motivating factors for the East.

The German people are now experiencing the consequences of their rapid reunification: the West shoulders a tremendous financial burden and restructuring responsibility, while the East suffers sudden and previ-

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79. *Id.*
80. Nawrocki, *supra* note 78.
81. *Id.*
82. Carl-Christian Kaiser, *Gut Verdraengt is Halb Gewonnen*, DIE ZEIT, Mar. 6, 1992, at 21.
83. Thies, *supra* note 43.
84. Interview with Corinna Machnow, computer technician with Siemens-Nixdorf AG in Lakewood, Colorado (January 1992).

ously unknown unemployment and economic depression. Both face a stressful and uncertain future. A slower and more deliberate strategy would have allowed for a greater opportunity to prepare and adjust. Additionally, a more planned approach possibly could have offered opportunities for creative development not only of the Eastern, but also of the Western political and economic structure.

Looking forward, the new states of the East are likely to adjust, and an overall economic recovery is likely to occur in the East in the near future. However, the psychological and cultural re-approachment and the confrontation with the East's dictatorial history presents a problem that will take much longer to settle among the newly unified German people.

Floy Jeffares

INTERNATIONAL CAPITAL MARKETS SECTION

The Multijurisdictional Disclosure System and Other Cross-Border Offerings*

HAROLD S. BLOOMENTHAL**
SAMUEL WOLFF***

§ 1.01 Introduction

[1] *The MJDS*

The Securities and Exchange Commission has made "achieving a truly global market system" a top priority.[1] The Commission's focus on international securities markets led it to undertake several significant initiatives, including the adoption in April of 1990 of Regulation S,[2] relating to offshore distributions, and Rule 144A,[3] designed to improve the efficiency of private placement markets in the United States for all securities, but particularly foreign securities. The Commission also took the first steps toward a multijurisdictional disclosure system ("MJDS") that initially involves a reciprocal arrangement between the United States and Canada under which each country is to accept for certain issuers the disclosure document prepared and reviewed under the laws and procedures of the home country.[4] Concurrently with the Commission's action, the Ca-

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1. *See* press release relating to SEC, "Policy Statement on Regulation of International Securities Markets" (November 14, 1988 Press Release).

2. Sec. Act Rel. No. 6863, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,524 (April 24, 1990).

3. Sec. Act Rel. No. 6862, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,523 (April 23, 1990).

4. Sec. Act Rel. No. 6902, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,812 (June 21, 1991) [hereinafter the "MJDS Release"]. The MJDS was initially proposed in Sec.

nadian Securities Administrators adopted a counterpart disclosure system for U.S. issuers offering securities in Canada.[5]

The MJDS, although limited in scope by eligibility requirements, is as broad as the disclosure system cutting across registration under the Securities Acts, reporting under the Exchange Act, and tender offers. The MJDS introduces Securities Act Registration Forms F-7, F-8, F-9, and F-10 available to qualified Canadian foreign private issuers for, respectively, rights offerings, exchange offers and business combinations, investment grade senior securities, and for the offering of any security other than certain specified derivative securities.[6] To be eligible to use these forms the Canadian foreign private issuer generally has to meet specified Canadian reporting requirements and, in some instances, substantiality criteria. Form F-10, the only form not restricted by the type of offering, requires that the issuer have a three year reporting history with a Canadian regulatory authority and a market capitalization in its outstanding equity securities of not less than (CN) $360 million with a public float in such securities of not less than (CN) $75 million.[7] MJDS also provides for a Form 40-F that permits qualified foreign private issuers to satisfy Exchange Act reporting requirements by wrapping around the reports filed with Canadian regulatory authorities.[8] In tender offers for Canadian foreign private issuers, tenders can, under certain circumstances, be solicited from U.S. holders by complying with applicable Canadian Law and filing the Canadian materials with the SEC on a Schedule 14D-1F, 14D-9F, or 13E-4F, as appropriate.[9]

[2] *The Cross Border Proposals*

The Commission has also proposed other initiatives that are applicable to all foreign issuers, not merely Canadian issuers, in the limited area of cross-border rights offerings,[10] exchange offers, business combinations and tender offers.[11] The problem the Commission sought to address in these proposals is the tendency of foreign market participants to exclude U.S. security holders from predominantly foreign transactions due to the

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Act Rel. No. 6841, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,432 (July 24, 1989) [hereinafter the "Proposing Release"] and reproposed Securities Act Release No. 6879, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,701 (Nov. 2, 1990) [hereinafter the "Reproposing Release"].

5. *See infra* §1.16.

6. *See infra* §1.04[1].

7. Form F-10, General Instructions I.C(4)-(5), [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶7042 (July 1, 1991) [hereinafter Form F-10].

8. *See infra* §1.10[3].

9. *See infra* §1.12[1].

10. Cross-Border Rights Offers; Amendments to Form F-3, Sec. Act Rel. No. 6896, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,802 (June 5, 1991) [hereinafter Rel. 6896].

11. International Tender and Exchange Offers, Securities Act Release No. 6897, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,803 (June 5, 1991) [hereinafter Rel. 6897].

burdens of complying with the U.S. securities laws.[12] Rather than risk "violating the 1933 Act," according to institutional investors, "issuers have often systematically excluded U.S. persons from such [rights] offerings."[13] Bidders similarly have excluded U.S. holders from tender offers for foreign issuers when faced with the disclosure and substantive requirements of the Williams Act.[14] The Commission's 1991 proposals are designed to address these practices.[15]

The cross border provisions in some respects go beyond the U.S.-Canadian MJDS, including exemptions from registration under the Securities Act for rights offerings, exchange offerings, and business combinations, involving foreign private issuers where the amount offered in the United States does not exceed $5 million.[16] The Commission also proposed a new registration form, Form F-11,to allow the registration of equity securities offered in rights offerings without regard to the size of the offering in the United States or elsewhere[17] and a new registration form, Form F-12, which would be available for securities issued in qualifying exchange offers and business combinations.[18] Allowing qualified foreign private issuers to effect such offerings to U.S. shareholders using disclosure documents prepared in accordance with home country requirements. The financial statements, if any, included in the disclosure documents would not be required to comply with U.S. generally accepted accounting principles or auditing standards.[19] A registration statement on Forms F-11 and F-12 would become effective upon filing.[20] The Commission proposed related exemptions from the continuous reporting provisions of the Securities Exchange Act of 1934 (the "Exchange Act").[21] The Commission also proposed to amend its rules under the Williams Act to exempt from the disclosure and substantive provisions thereof tender offers for securities of foreign private issuers if ten percent or less of the outstanding class of securities subject to the tender offer is held by U.S. holders.[22] The exemption provided by Rule 14d-1(c) will be available to both foreign and U.S. bidders if the target company is a foreign private issuer and the other conditions of the Rule are met.[23] Finally, the Commission proposed

12. Rel. 6896, *supra* note 10, at 81,717.

13. *Id.*

14. Rel. 6897, *supra* note 11, at 81,743.

15. Rel. 6896, *supra* note 10, at 81,717; Rel. 6897, *supra* note 11, at 81,744.

16. Proposed Rule 801 under the Securities Act, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,802, at 81,730 [hereinafter Rule 801]; Proposed Rule 802 under the Securities Act, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,803, at 81,767 [hereinafter Rule 802].

17. Proposed Form F-11, Rel. 6896, *supra* note 10 at 81,736 [hereinafter Form F-11].

18. Proposed Form F-12, Rel. 6896, *supra* note 10, at 81,780 [hereinafter Form F-12].

19. Rel. 6896, *supra* note 10, at 81,725; *See infra* §1.06[2].

20. *Id.* at 81,724.

21. *See infra* §1.10[1].

22. Proposed Rule 14d-1(c), [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,803, at 81,775 [hereinafter Rule 14d-1(c)]; *See infra* §1.12[2].

23. Rel. 6897, *supra* note 11, at 81,747; *See infra* §1.12[2].

an exemptive order to address a number of issues arising in takeover bids for U.K. companies with U.S. shareholders.[24] The exemptive order would permit third-party exchange and cash tender offers for U.K. target companies that are subject to the City Code on Takeovers and Mergers to proceed without compliance with certain of the provisions of the Williams Act.[25]

The Commission has adopted a rule that exempts all foreign private issuers from the requirements of Section 14 of the Exchange Act and the proxy and other rules adopted thereunder and the reporting, short swing profit and other provisions of Section 16 of the Exchange Act.[26] These provisions are significant in that registration of a class of securities under Section 12 of the Exchange Act ordinarily subjects the registrant to the proxy rules and the provisions of Section 16. Foreign private issuers that register a class of securities under the Exchange Act are not subject to such provisions.[27]

MJDS and the cross-border proposals although two separate packages are, with some important nuances, the beginning of a unitary system bound together by the acceptance, under limited circumstances, of foreign disclosure to satisfy U.S. requirements. Securities Act registration under the cross border proposals is limited to rights offerings, exchange offers and business combination. MJDS, on the other hand, also is applicable to Securities Act registration of investment grade senior securities and to all offerings of certain substantial Canadian issuers. MJDS is in place and is limited to Canadian private issuers (and in some instances crown corporations). The cross-border proposals, if adopted, will be applicable to all foreign private issuers, including Canadian foreign private issuers. The approach in this Article is to combine and compare MJDS and the cross-border proposal to the extent practicable. The reader can facilitate this comparison by reference to Appendices one through five which present tabular comparisons of eligibility criteria and other relevant information pertaining to the applicable forms. Such comparisons reveal differences in eligibility criteria and otherwise between the MJDS and the cross-border proposals, and among the various forms, that in some instances defy rationalization. Hopefully, the cross border proposals when adopted will eliminate unwarranted differences.

§1.02 Some Common Definitions

Several of the MJDS forms share a number of common definitions and several of these definitions also are applicable to the cross-border offering forms and exemptions (indicated below by inclusion of an asterisk).

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24. *Id.* at 81,761; *See infra* §1.12[3].

25. *Id.*

26. Rule 3a-12-3 under the Securities Act, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶21,193 [hereinafter Rule 3a-12-3].

27. *See infra* §1.03 for the definition of a foreign private issuer.

The important common definitions include the following:

An "affiliate" is "any person who beneficially owns, directly or indirectly, or exercises control or direction over, more than ten percent of the outstanding equity shares of such person . . . as of the end of such person's most recently completed fiscal year."[28]

A "business combination" is "a statutory amalgamation, merger, arrangement or other reorganization requiring the vote of shareholders of the participating companies. . . ." [29]

A "crown corporation" is "a corporation all whose common shares or comparable equity is owned . . . by the government of Canada or a province or territory of Canada."[30]

"Equity Shares" under Forms F-8 and F-10 and proposed Form F-12 means "common shares, non-voting equity shares and subordinate or restricted voting equity shares, but" not preferred shares.[31] In the case of MJDS Form F-7 relating to rights offerings and which is not limited to an offering of equity securities, the term equity shares or equity securities is not defined. Proposed Form F-11, which is limited to a rights offering of equity securities incorporates the Rule 405 definition of "equity security" which includes "any stock or similar security," but, unlike Rule 405, excludes securities convertible into equity securities and certain warrants or rights to purchase or sell an equity security.

"Market value" for purposes of determining the market capitalization of the registrant's outstanding equity shares and for the purpose of determining the market value of the public float of the registrant's outstanding equity shares is "computed by use of the price at which such shares were last sold, or the average of the bid and asked prices of such shares, in the principal market for such shares as of a date within sixty days prior to the date of filing. If there is no market for any such securities, the book value of such securities computed as of the latest practicable date prior to the filing . . . shall be used . . . unless the issuer of such securities is in bankruptcy or receivership or has an accumulated deficit, in which case one-third of the principal amount, par value or state value of such securities shall be used."[32]

A "participating company" is a party to a business combination. A

28. Form F-8, General Instructions I.C, [1989 Transfer Binder] Fed Sec. L. Rep. (CCH) ¶7022 (July 1, 1991)[hereinafter Form F-8]. The citations relating to definitions are representative rather than for each of the forms or applicable rule. To the extent any of the forms or applicable rule uses such defined terms, the definition is uniform.

29. *Id.*, General Instructions I.A; Rule 802(a)(6), *supra* note 16; Form F-12, *supra* note 18, General Instructions I.A.

30. Form F-9, General Instructions I.B, Instruction 2, [1989 Transfer Binder] Fed.Sec. L. Rep. (CCH) ¶7032 (July 1, 1991) [hereinafter Form F-9].

31. Form F-10, *supra* note 7, General Instructions I.C, Instruction 3; Form F-12, *supra* note 18, Instructions for Form F-12, No. 3.

32. Form F-10, *supra* note 7, General Instructions I.C, Instruction 4; Form F-12, *supra* note 18, Instructions for Form F-12, No. 5.

"small non-conforming participating company," is a company participating in a business combination that is not required to meet the substantiality and continuous reporting requirements of the relevant form because "other participating companies, whose assets and gross revenues, respectively, would contribute at least eighty percent of the total assets and gross revenues from continuing operations of the successor Registrant, as measured based on pro forma combination of the participating companies' most recently completed fiscal years immediately prior to the business combination, each meet" such requirements.[33] Neither of these terms are a specifically defined term in the Forms, but are used as a convenient means of exposition in this Chapter.

"Public float" for purposes of the MJDS means only the "securities held by persons other than affiliates of the issuer."[34] Public float for purposes of the cross border proposals means "only such securities held by persons other than U.S. holders of more than ten percent of the issuer."[35]

A "U.S. holder" means "any person whose address appears on the records of the issuer of subject securities [on the records of a participating company, in the case of a business combination] any voting trustee, any depositary, any share transfer agent or any person acting in a similar capacity on behalf of the issuer of the subject securities [on behalf of a participating company, in the case of a business combination] as being located in the United States."[36] The determination of the percentage of shares held by U.S. holders in connection with a business combination is determined as of the end of each participant's last fiscal quarter unless the quarter ended within sixty days (180 days in the case of Form F-12) of the filing date in which event it is determined as of the preceding quarter.[37]

§1.03 Foreign Private Issuer

The concept of a "foreign private issuer" is critical to MJDS as well as the cross-border proposals. The MJDS is limited to an issuer incorporated or organized under the laws of Canada or any Canadian province or territory that is a foreign private issuer or, in the case of Form F-9, a crown corporation.[38] The cross-border proposals for the most part are ap-

33. Form F-10, *supra* note 7, General Instructions I.C(3)-(5); Form F-12, *supra* note 18, General Instructions 1-B(3).

34. Form F-10, *supra* note 7, General Instructions I-G, Instruction 1 and 2.

35. Form F-12, Instructions for Form F-12, No. 5. In fact, the two definitions reach the same results as the MJDS defines an affiliate in effect as one holding more than 10% of the issuer.

36. Form F-8, *supra* note 28, General Instructions II.D, Instruction 1; Form F-12, *supra* note 18, Instructions for Form F-12, No. 6.

37. Form F-8, *supra* note 28, General Instructions III.B, Instruction 2; Form F-12, *supra* note 18, Instructions for Form F-12, No. 9.

38. All of the MJDS forms have substantially identical general instructions relating to the basic Canadian orientation of the issuer. Thus Form F-10, General Instruction I.C(1)(2) includes as eligibility requirements that the issuer be incorporated or organized under the

plicable to foreign private issuers, but are not limited to Canadian foreign private issuers. A corporation organized outside the United States is not a foreign private issuer if[39] (i) more than fifty percent of the outstanding voting securities of such issuer is held of record, either directly or through voting trust certificates or depositary receipts, by persons for whom an U.S. address appears on the records of the issuer, its transfer agent, voting trustee or depositary; *and* (ii) *any* of the following factors are present: (A) the majority of the executive officers or directors of the issuer are U.S. citizens or residents; (B) more than fifty percent of the assets of the issuer are located in the United States; *or* (C) the business of the issuer is administered principally in the United States.

§1.04 The Basic MJDS and Cross Border Registration Forms and Eligibility Requirements

[1] *The MJDS Forms*

The MJDS Forms for registration of securities under the Securities Act, and related eligibility requirements, are as follows:

Form F-10 is available for any type of security (except for certain derivative securities) and any type of offering by a Canadian private issuer, provided the issuer satisfies the eligibility requirements.[40] The issuer must have been subject to the continuous disclosure requirements of any Canadian securities commission or equivalent regulatory authority in Canada for 36 consecutive months and be currently in compliance with such reporting requirements.[41] The market capitalization of its outstanding equity securities must be (CN) $360 million or more *and* the market capitalization of the public float of its equity shares must be (CN) $75 million or more.[42] All of the participating companies in a business combination must be Canadian foreign private issuers and all participating companies, except for small non-conforming participating companies,[43] must meet the market value, float, and reporting requirements for Form F-10 eligibility.[44] Form F-10 may be used for an offering of derivative securities consisting of warrants, options, rights (collectively "warrants"), and convertible securities provided the warrants and securities underlying the warrants or the convertible security and the security into which converti-

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laws of Canada or any Canadian province or territory and that it be a foreign private issuer. Instruction 1 to General Instruction I defines a foreign private issuer by reference to Rule 405. Form F-9, General Instructions I.B also includes a crown corporation and instruction 2 defines a crown corporation.

39. Rule 405, Under Securities Act Regulations, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶5803 [hereinafter Rule 405]; Rule 3b-4, Under the Securities Act [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶21,255 [hereinafter Rule 3b-4].

40. *See* Form F-10, *supra* note 7, General Instruction I.C(1)-(2).

41. *Id.*, General Instruction I.C(3).

42. *Id.*, General Instruction I.C(4)-(5).

43. *See* supra note 33.

44. Form F-10, *supra* note 7, General Instruction I.C(3).

ble are issued by the Registrant, its parent or an affiliate of either. Form F-10 cannot otherwise be used to register derivative securities.[45]

Form F-9 is limited to investment grade debt securities or preferred stock offered for cash or in connection with an exchange offer by a Canadian private issuer or crown corporation that has been subject to the continuous disclosure requirements of any Canadian securities commission or equivalent regulatory authority for thirty six consecutive months (twelve months, in the case of a crown corporation) and is currently in compliance with such reporting requirements.[46] The investment grade refers to the four highest grades accorded by at least one nationally recognized statistical rating organization.[47] Form F-9 can be used for investment grade convertible securities only if they cannot be converted for a period of at least one year from the date of issuance and only if convertible into a security of another class of the issuer or[48], in the case of convertible securities offered by a subsidiary into securities of the parent.[49] In the limited circumstances under which Form F-9 can be used to offer convertible securities, the issuer also must satisfy a substantiality requirement measured by a market capitalization of (CN) $180 million and a public float of (CN) $75 million.[50] There are special requirements to the use of Form F-9 in connection with an exchange offer. See 1.07[1].

Form F-7 is available for any rights offering to security holders for cash by a Canadian private issuer that has a class of securities that have been listed on the Montreal or Toronto Stock Exchanges or the Senior Board of the Vancouver Stock exchange for at least twelve months preceding the offering *and* has been subject to the continuous disclosure requirements of any securities commission or equivalent regulatory authority in Canada for at least the immediately preceding thirty six months and is currently in compliance with applicable listing and reporting requirements.[51] The rights issued to U.S. holders must be granted on terms and conditions not less favorable than those afforded to other holders of the same class of securities.[52] The rights (but not the underlying securities) must be restricted so that they may not be transferred except in an offshore transaction in compliance with Regulation S.[53]

Form F-8 is available for an exchange offer being made by a Canadian private foreign issuer that has a class of securities that have been listed on the Montreal or Toronto Stock Exchanges or the Senior Board

45. *Id.*, General Instruction I.B.
46. Form F-9, *supra* note 30, General Instruction I.A-I.B.
47. *Id.*, General Instruction I.A.
48. *Id.*
49. *Id.*, General Instruction I.E.
50. *Id.*, I.B(4)-(5).
51. Form F-7, General Instruction I.A and I.B., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶7012 (July 1, 1991)[hereinafter Form F-7].
52. *Id.*, General Instruction I.D.
53. *Id.*

of the Vancouver Stock exchange for at least twelve months preceding the offering *and* has been subject to the continuous disclosure requirements of any securities commission or equivalent regulatory authority in Canada for at least the immediately preceding thirty six months and is currently in compliance with applicable listing and reporting requirements. If the registrant is other than the issuer of the securities being offered, the registration must have a public float of outstanding equity shares with a market value of (CN) $75 million or more. The offer must be made to the shareholders of another Canadian issuer for a class of securities as to which U.S. holders hold of record less than twenty five percent of the class. Form F-8 can be used for an offering of derivative securities only if such securities consist of warrants, options, rights (collectively "warrants"), or convertible securities and provided the warrants and securities underlying the warrants or the convertible security and the security into which convertible are issued by the Registrant, its parent or an affiliate of either.

Form F-8 is also available for a statutory business combination requiring the vote of participating companies if all the participating companies are Canadian issuers and less than twenty five percent of the shares of the surviving entity will be held of record by U.S. holders immediately after the completion of the business combination. Each participating company, other than small non-conforming companies as defined above,[54] must meet the listing/reporting requirements applicable to the use of Form F-8 in connection with an exchange offering. Each participating company, other than a small non-conforming company as defined above, must have a public float of equity shares with a market value of (CN) $75 million except under certain specific circumstances involving a participant that was the subject of an exchange or tender offer during the preceding twelve months.

Form F-80 is identical in very respect to Form F-8, except it can be used provided U.S. holders hold less than forty percent of the outstanding class as distinguished from twenty five percent as under Form F-8 of the securities of the target company in the case of an exchange offer or of the resulting company in the case of a business combination. The Commission, having determined that a less than a forty percent U.S. interest is a sufficient threshold at which it is willing to accept Canadian disclosure, provided for duplicative forms with the one difference in eligibility requirements to accommodate those state blue sky commissioners that regard twenty five percent U. S. holdings as a more appropriate threshold. A reference hereafter to Form-8 should also be deemed a reference to Form F-80 unless specifically stated to the contrary.

The MJDS forms in all instances are available only if the registrant is subject to relevant Canadian disclosure and filing requirements. None of the forms are available to a company registered or required to register

54. *See supra* note 33.

under the Investment Company Act, although it is available to investment companies not required to register under the Investment Company Act.[55] None of the forms are available to issuers, which, although organized under the laws of Canada, are not foreign issuers for purposes of the Exchange Act.[56]

[2] *Forms F-11 and F-12*

Form F-11, if adopted, will be available for the registration of equity securities to be sold for cash upon the exercise of rights granted by qualified foreign private issuers.[57] The issuer would be allowed to register securities on Form F-11 if it met the Common Eligibility Requirements and the other conditions of the Form. In general, the issuer must be a foreign private issuer that is a "reporting issuer"[58] or exempt from reporting pursuant to Rule 12g3-2(b).[59] In the latter case, the issuer must have a security listed or quoted on a designated offshore securities market (DOSM)[60] *and* have been listed or quoted the immediately preceding thirty six months *or* have a public float of $75 million.[61] The issuer must grant the rights to U.S. holders in proportion to the securities they hold and upon terms and conditions no less favorable than those extended to other holders.[62] The rights themselves may not be transferable except in accordance with Regulation S under the Securities Act.[63] Rights, transferability of Form F-11 generally is not available if the issuer is an investment company registered or required to be registered under the Investment Company Act.[64] The Form is available irrespective of the aggregate offering price, the amount offered in the United States, the percentage of U.S. shareholders to whom the rights are issued or the number of shares outstanding attributable to the offering. The fact that an unlimited amount of securities may be registered on Form F-11 will make the Form extremely useful to foreign private issuers, especially in light of the facts that: (i) U.S. accounting, auditing and auditor independence principles

55. Form F-7, *supra* note 51, General Instruction I.E; Form F-8, *supra* note 28, General Instruction I.B; Form F-9, *supra* note 30, General Instruction I-G; Form F-10, *supra* note 7, General Instruction I-C.

56. *See infra* §1.03.

57. Form F-11, *supra* note 17, General Instructions I.A. Cf. Form F-12, which is available for the registration of equity or debt securities.

58. A reporting issuer for this purpose is a company required to file reports pursuant to Section 15(d) or Section 13(a) of the Exchange Act that has filed all reports due during the immediately preceding 12 months (or such shorter period as the issuer was required to file reports). Form F-11, General Instructions I.B.

59. Form F-11, *supra* note 17, General Instruction I.B.

60. DOSMs include most of the major offshore exchanges and were initially designated in accordance with Rule 902(a) of Regulation S.

61. Form F-11, *supra* note 17, General Instruction I.B(2).

62. *Id.*, General Instruction I.A., I.D.

63. *Id.*, General Instruction I.D.

64. *Id.*, General Instruction I.B., Instruction 2.

will be inapplicable;[65] (ii) offerings of securities registered on Form F-11 will not give rise to continuous reporting obligations[66] or be subject to Rules 10b-6, 10b-7 and 10b-8, if certain conditions are met;[67] and (iii) rights offerings are common methods of financing abroad.[68]

The Commission also proposed a new Form F-12 may be used for the registration by foreign private issuers for equity or debt securities.[69] In connection with exchange offers and business combinations that are primarily foreign in character. In exchange offers, not more than five percent of the class of securities that is the subject of the exchange offer can be held by U.S. holders, other than U.S. holders of more than ten percent of the subject class.[70] In business combinations, not more than five percent of the class of securities being offered in the exchange offer by the registrant can be held by U.S. holders, excluding U.S. holders of more than ten percent, as measured upon completion of the business combination.[71] The registrant must be a foreign private issuer, have a class of securities registered under Section 12 of the Exchange Act or be reporting pursuant to Section 15(d), and have filed all required materials for at least one year preceding the commencement of the offering (or such shorter period as the registrant was required to file such materials).[72] As an alternative to the reporting requirement the registrant may establish eligibility for Form F-12 by filing for an exemption from Exchange Act registration pursuant to the Rule 12g3-2(b).[73] In the case of an exchange offer, the registrant must have a class of equity securities that has been listed on a DOSM for the three years immediately preceding filing of the Form F-12, and be in compliance with its obligations arising from such listing, *or*, if (in addition to the other requirements) the issuer must have an equity security listed on a DOSM, a thirty six month operating history and a public float of at least $75 million, and be currently in compliance with its obligations arising from its DOSM listing.[74] U.S. holders must participate

65. Rel. 6896, *supra* note 10, at 81,716-81,717.

66. Proposed Rule 12h-5, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,803, at 81,736.

67. *See* Rel. No. 6986, *supra* note 10, at 81,728. Those conditions include a public float of $150 million, appropriate legend disclosure (*see infra* §1.13), disclosure in the United States of actual bids or purchases if disclosure is made of such information in a foreign jurisdiction, no bids or purchases effected in the U.S., and all bids and purchases effected on a DOSM.

68. *See* Rel. 6896, *supra* note 10, at 81,717-81,718. "Unlike their U.S. counterparts, foreign issuers frequently engage in rights offerings. . . ." Id. Rights offers are particularly common in the United Kingdom and Europe, where many countries have some form of preemptive right statutes . . . Rights offers are also common in British Commonwealth counties such as Australia and South Africa." *Id.*

69. Rel. 6897, *supra* note 11, at 81,753.

70. Form F-12, *supra* note 18, General Instruction I.B.1.(c).

71. *Id.*, General Instruction I.C.1.(c).

72. *Id.*, General Instruction 1.B.1., 1.C.1.

73. Rule 12g3-2(b) under the Exchange Act, 17 C.F.R. §240.12g3-2(b). *See infra* §1.10[2].

74. Form F-12, *supra* note 18, General Instruction 1.B.1.(d).

in the offer on terms no less favorable than those offered other holders of the same class,[75] except in the case of an offer prohibited by state law after good faith effort on the part of the registrant to register in such state.[76]

Form F-12 is available for business combinations where each company participating in the combination is a foreign private issuer[77] and meet other eligibility requirements. The registrant must be a reporting issuer or have filed the necessary documents pursuant to Rule 12g3-2(b) exemption from Exchange Act registration[78] on or before filing the Form F-12. In most instances, the registrant will be a successor corporation organized for purposes of the business combination, which will necessitate that it take affirmative steps to meet this requirement. The Form is not available if more than five percent of the class being offered is held by U.S. holders (other than U.S. holders of more than ten percent),[79] as of the completion date of the business combination.[80] Each participating company in the business combination, other than the successor registrant and other than a non-conforming small company participant,[81] must have had a class of equity securities listed on a DOSM for thirty six months immediately preceding the filing of the Form F-12, and must be in compliance with its obligations arising therefrom. If a participating company does not meet the thirty six month listing requirement, Form F-12 would still be available if such company has a class of equity securities currently listed on a DOSM, has a three year operating history and a public float of $75 million or more, and is currently in compliance with its obligations arising from the listing.[82] As in the case of exchange offers, business combinations must be structured so that U.S. holders participate on terms no less favorable than those of other holders with an exception for holders in any state which prohibits an offer after a good faith effort by the issuer to register securities in such state.[83]

Form F-12 is less liberal than the counterpart Form F-8 relating to MJDS business combinations and exchange offers in terms of the allowable U.S. interest (five percent in the case of F-12 and twenty five percent

75. Form F-2, General Instructions B.2, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶6962 (December 4, 1982) [hereinafter Form F-2].

76. *Id.* The issuer in such event may offer shareholders in that state a cash alternative, but only if such cash alternative is offered to shareholders in all other states in which it was unable to register the securities.

77. A reporting issuer for this purpose is a company required to file reports pursuant to Section 15(d) or Section 13(a) of the Exchange Act that has filed all reports due during the immediately preceding 12 months (or such shorter period as the issuer was required to file reports). Form F-12, Instructions for Form F-12, No. 2.

78. *See infra* §1.10[2] for a discussion of the Section 12g3-2(b) exemption.

79. Form F-12, *supra* note 18, General Instruction C.1.(c).

80. *Id.*

81. *Id.*; *See supra* note 33 for the criteria relevant to allowable non-conforming companies.

82. Form F-12, *supra* note 18, General Instruction C.1.(c).

83. *Id.*, General Instruction C.2.

in the case of F-8), but unlike Form F-8 in determining the allowable U.S. interest U.S. holders that are affiliates (have a ten percent or greater interest) are excluded in determining the extent of the U.S. interest. Any foreign private issuer could make an exchange offer under proposed Rule 802 up to $5 million without regard to amount of shares of the target held by U.S. holders provided the conditions of that exemption are complied with. For example, see the discussion in §1.11[2].

[3] *Proposed Amendments to Form F-3*

Form F-3 is the counterpart for foreign issuers to Form S-3, which allows qualified registrants to use a prospectus that consists primarily of a description of the offering and the distribution terms and incorporates by reference the balance of the prospectus from filings made pursuant to Exchange Act reporting requirements.[84] Any foreign private issuer which meets the Registrant Requirements[85] of Form F-3 may use the Form for the registration of securities to be offered in any transaction which meets the Transaction Requirements[86] of that Form. Form F-3 is presently limited to certain so-called "world-class" issuers that satisfy a 3 year reporting requirement[87] and have a float of $300 million.[88] In conjunction with the cross border proposals, the Commission proposed to amend Form F-3 to eliminate the three-year reporting and $300 million float requirements in connection with certain transactions.[89] Under the proposals, a registrant that is a reporting issuer can offer securities issuable in connection with rights offerings, dividend or interest reinvestment plans, and conversions or warrants without regard to a three year reporting history and a $300 million float.[90] Under the proposals registration statements on Form F-3 relating solely to securities offered in the foregoing transactions would become effective automatically upon filing.[91] Thus, a foreign private issuer that is a reporting issuer could use Form F-3 for a rights offer-

84. *See* 3 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW [hereinafter "SFCL"] §15.13[2][a].

85. Form F-3, General Instruction I.A, [1989 Transfer Binder] Fed. Sec. L. rep. (CCH) ¶6972 (December 4, 1982) [hereinafter Form F-3].

86. *Id.*, General Instruction I.B.

87. Form F-3, *supra* note 85, General Instruction I.A.2. The issuer, however, would have to be a reporting company and have filed at least one annual report (presumably on Form 20-F). Form F-3, *supra* note 85, General Instruction 1.A.1. Although the instruction literally requires that the issuer have filed "annual reports", which suggests more than one such report; presumably, this is an oversight that failed to correct the previous instruction which assumed that the registrant would be subject to a three year reporting history.

88. Form F-3, *supra* note 85, General Instruction I.A.4. Under current law the aggregate market value worldwide of the voting stock held by non-affiliates of the registrant must be the equivalent of $300 million or more.

89. Proposed Amendments to Form F-3, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,802, at 81,734.

90. Rel. 6896, *supra* note 10, at 81,726.

91. Proposed Amendment to Rule 468 under the Securities Act, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,802, at 81,730.

ings (or the other specified offerings), assuming it meets the other relevant conditions to the use of the Form which require that it have not failed to pay any of its debt or long term lease obligations, dividend or sinking fund payments relating to preferred stock which, failure(s), in the aggregate, are material.[92] A foreign issuer meeting the eligibility requirements for both Forms F-11 and F-3 (as amended) could register securities on either Form.[93]

§ 1.05 The Reporting and Substantiality Requirements

[1] *Under MJDS*

[a] Three-Year History of Continuous Reporting

The MJDS requires that the issuer have at least a three year (thirty six calendar months immediately preceding the filing) history of continuous reporting, and to be in compliance with all reporting requirements at the time of filing. In the case of a Form F-10 or F-9 registration statement, the three year reporting history can be pursuant to the continuous disclosure requirements of any securities commission or equivalent regulatory authority in Canada.[94] In the case of a Form F-7 (rights offering) or Form F-8 (exchange offering or business combination), in addition to the three year reporting requirement, the issuer (participating issuers in the case of a business combination) must have had a class of securities listed on the Montreal Toronto, or Vancouver (Senior Board only) Stock Exchanges during the twelve calendar months immediately preceding the filing of the registration statement.[95]

[b] Substantiality Requirements

Besides satisfying the continuous reporting or listing requirements, as is appropriate, the issuer in many instances must meet a substantiality criterion. As the Commission explains:

> The purpose of the 'substantial' designation is to single out issuers whose size is such that there is a large market following for them and the marketplace can be expected to have set a price for their securities based on all publicly available information.[96] 28[ ] The Commission has distinguished for this purpose between investment grade securi-

92. Form F-3, *supra* note 85, General Instruction I.A.3.

93. Rel. 6896, *supra* note 10, at 81,727.

94. Form F-10, *supra* note 7, General Instruction I-C(3); Form F-9, *supra* note 31, General Instruction I-A and B.

95. Form F-7, *supra* note 51, General Instruction I-A and B; Form F-8, *supra* note 28, General Instruction II-A(3) and III-A(2).

96. "Compare Securities Act Release No. 6331 (August 6, 1981) (adopting Form S-3) ("Because these registrants are widely followed, the disclosure set forth in the prospectus may appropriately be limited, without the loss of investor protection, to information concerning the offering and material facts which have not been disclosed previously.")."

ties and other securities and has provided separate registration forms for each.[97]

Substantiality is reflected by the capitalization at market value of the issuer's outstanding equity shares,[98] or the public float in its outstanding equity shares, and, in some instances, of both. Market capitalization is determined by multiplying the number of outstanding equity shares by their market value and public float is similarly determined by multiplying the number of public float equity shares by market value at the appropriate selected date.[99] For a Form F-10 registration, which can be for any kind or quality of security, the market capitalization has to be at least (CN) $360 million and the public float (CN) $75 million.[100] For Form F-9, which is available only for investment grade debt and preferred stock, there are no substantiality requirements if the securities are not convertible. If they are convertible (and can be only under the limited circumstance that the conversion right is not exercisable for a year), the market capitalization and float minimums are at least (CN) $180 million market capitalization and (CN) $75 million public float.[101] To be able to use Form F-8 (for an exchange offer or business combination), the substantiality criterion is met by having (CN) $75 million in public float.[102] In the case of a business combination, the float requirement must be met by each participating company other than small non-conforming companies.[103] Only a rights offering on Form F-7, a non-convertible debt and equity offering on Form F-9, and an exchange offering on Form F-8 by an issuer to its own securities holders[104] do not have to meet a substantiality criterion.

In an offering on Form F-10 of non-convertible debt or preferred stock, the continuous reporting requirement and the market tests of substantiality can be satisfied for a majority owned subsidiary by its parent, provided the parent has fully and unconditionally guaranteed the registered securities as to principal and interest (if debt securities) or as to liquidation preference, redemption price and dividends (if preferred se-

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97. MJDS Release, *supra* note 4, at 81,866-81,867.

98. Equity shares includes common shares, non-voting equity shares, and subordinated or restricted equity shares, but not preferred shares. *See* Form F-10, *supra* note 7, General Instruction I-B, Instruction 5; F-8, *supra* note 28, at 6132, General Instruction II-A, Instruction 3.

99. *See supra* §1.02 for the definition of market capitalization and public float.

100. Form F-10, *supra* note 7, General Instruction I-C(4).

101. Form F-9, *supra* note 30, General Instruction I-B(4)-(5).

102. Form F-8, *supra* note 28, General Instruction II-A(4), III-A(3).

103. *Id.*, General Instruction III-A(2). *See supra* note 34 for the definition of a small non-conforming company.

104. An exchange offer by an issuer made exclusively to its own security holders is exempt under Section 3(a)(9) of the Securities Act if no commission or other remuneration is paid for soliciting the exchange. Accordingly, registration and Form F-8 would be used only if the exemption were not available.

curities).[105] In an offering on Form F-9 of investment grade debt securities or preferred stock (including convertible securities if convertible only into securities of the parent), the continuous reporting requirement can be similarly met by the parent of a majority owned subsidiary that guarantees the registered security.[106] For the remaining MJDS eligibility requirements see Section 1.04[1].

[2] *Under the Cross Border Proposal*

The cross-border proposals have a counterpart exemption (Rule 801) to registration on Form F-11 for rights offerings and a counterpart exemption (Rule 802) to registration on Form F-12 for exchange offers and business combinations. The eligibility requirements for the Rule 801 exemption correspond to the eligibility requirements relating to registration on Form F-11 for rights offerings; the difference being that the offering under the Rule 801 exemption is limited in amount.[107] The discussion in this subsection relating to Form F-11 is applicable, therefore, to the Rule 801 exemption. The exemption under Rule 802, although relating to the same type of offerings as Form F-12, has different and less stringent eligibility requirements than Form F-12 and the discussion below relating to Form F-12 is not applicable to the Rule 802 exemption. For a discussion of Rule 802 see §1.11[2].

In the case of registration on Form F-11, if the registrant is a reporting issuer there is no further reporting or substantiality requirement.[108] A reporting issuer is one that is subject to the reporting requirements of the Exchange Act pursuant to Section 13(a) or Section 15(d) of the Exchange Act.[109] There is no requirement that it have been a reporting company for any specified time, but it must have filed all required reports during the immediately preceding twelve months or such shorter period that it was required to file reports.[110] If it is not a reporting issuer, it must be exempt from registration under the Exchange Act pursuant to Rule 12g3-2(b) AND its must have a class of securities listed or quoted on a DOSM.[111] In

105. Form F-10, *supra* note 7, General Instruction I-H.
106. Form F-9, *supra* note 30, General Instruction I-E.
107. *See infra* §1.11 for a discussion of the exemptions.
108. Form F-11, *supra* note 17, General Instruction I-B(1).
109. Form F-11, *supra* note 17, General Instruction I-B, Instruction 2.
110. *Id.*
111. Form F-11, *supra* note 17, General Instruction I-B(2). A "designated offshore securities market" (DOSM) has the same meaning as in Rule 902(a) of Regulation S. Under Regulation S, a "designated off-shore securities market means (i) any foreign securities exchange or non-exchange market designated by the Commission; or (ii) the Eurobond market; the Amsterdam Stock Exchange; the Australian Stock Exchange; the Bourse de Bruxelles; the Frankfort Stock Exchange; the Stock Exchange of Hong Kong; the International Stock Exchange of the United Kingdom and the Republic of Ireland; the Johannesburg Stock Exchange; the Bourse de Luxembourg; the Borsa Valori Di Milan; the Montreal Stock Exchange; the Bourse de Paris; the Stockholm Stock Exchange; the Tokyo Stock Exchange; the Toronto Stock Exchange; the Vancouver Stock Exchange; and the Zurich Stock Exchange. Rule 902 of Regulation S, 17 C.F.R. §230.902(a). Since the adoption of Regulation S,

addition, it must either have a public float[112] of $75 million or have maintained its listing on the DOSM for 36 consecutive months immediately preceding the commencement date of the offering.[113]

In the case of Form F-12, the registrant (each participating company other than a small non-conforming company in the case of a business combination)[114] must either be a reporting issuer or have prior to filing on Form F-12 made an initial submission of the information required by the Rule 12g3-2(b) exemption from registration under the Exchange Act.[115] In the case of Form F-12, being a reporting issuer is not sufficient, however, to satisfy the reporting requirements. The registrant must also have a class of securities listed on a DOSM and be in full compliance with its listing obligations.[116] The listing must have been for the thirty six months immediately proceeding the filing of the registration statement *or* it must have a thirty six month operating history *and* a public float of $75 million or more.[117]

Form F-11 and F-12 state the DOSM requirement differently. In the case of Form F-11, the class of equity securities can be listed or quoted on a DOSM.[118] In the case of a Form F-12 literally the security must be listed on the DOSM.[119] One might assume based on this distinction that Form F-12 requires admission to the official list as distinguished, for example, being admitted for dealings on the Unlisted Securities Market of the International Stock Exchange in London. It is not entirely clear whether the difference is a result of deliberate or sloppy drafting. The Release in describing the eligibility requirements for an "offeror" ignores this distinction and paraphrases this requirement as if it is identical under both forms (i.e. can be listed or quoted on a DOSM). This is confusing as in the case of a business combination the offeror is typically a successor registrant that is excluded from the requirement that it have a class of securities listed on a DOSM.[120] Rather it is the other participants

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the Commission has designated other offshore securities markets as qualifying under this provision. These include the Helsinki Stock Exchange and the Mexican Stock Exchange. Rel. 6896, *supra* note 10, at 81,720 n.47. The staff has also indicated that trades on the U.K.AEs SEAQ qualify as trades on a DOSM. *Id.*

112. *See supra* §1.02 for the definition of public float.

113. Form F-11, *supra* note 17, General Instruction I-B(2).

114. *See supra* note 34 for definition of participating companies and non-conforming small company.

115. Form F-12, *supra* note 18, General Instructions I-B(1)(b), I-C(1)(b).

116. Form F-12, *supra* note 18, General Instructions I-B(1)(d), I-C(1)(d).

117. *Id.*

118. Rel. 6897, supra note 11, at 81,754.

119. Form F-12, *supra* note 18, General Instructions 1-C(1)(d). The exclusion for a successor registrant assumes that the business combination will always result in the formation of a new corporation and that under foreign law it is not possible to have a business combination in which one of the participants is the surviving corporation and the registrant. Presumably, in such an event, the registrant would not be excluded from the listing and related requirements.

120. Rel. 6897, supra *note* 11 at 81,757. (emphasis added).

that must meet the DOSM requirement. Further, the Release in specifically discussing the Form F-12 requirements relating to participants in a business combination refers to "a security listed on a" DOSM. Further, the relevant thirty six month period is measured from the commencement of the offering in the case of Form F-11 and from the date of the filing in the case of Form F-12.

For the remaining Form F-11 and F-12 eligibility requirements see Section 1.04[2].

Permitting foreign issuers to satisfy reporting requirements under appropriate circumstances by making filings under the Rule 12g3-2(b) exemption is a significant concession on the part of the Commission. The Rule 12g3-2(b) exemption is available to a foreign private issuer that furnishes to the Commission specified information that during its last fiscal year it made public pursuant to law, and/or filed with a stock exchange on which its securities are listed or distributed to its security holders.[121] To maintain the exemption provided by Rule 12g3-2(b) the issuer must furnish to the Commission during each subsequent fiscal year any information in the above-mentioned categories it has made public as described above.[122] To claim Rule 801 or use Form F-11 a non-reporting issuer must be ææ exempt from the requirements of Section 12(g) of the Exchange Act pursuant to Rule 12g3-2(b). . . .AEAE[123] A foreign private issuer submitting information to the Commission under Rule 12g3-2(b) but not exempt under Section 12(g) because it has not satisfied all of the terms of Rule 12g3-2(b) would thus appear to be ineligible for Rule 801 and Form F-11.[124]

An issuer that has been submitting material under Rule 12g3-2(b) should not assume that it is exempt from Section 12(g) but rather should review its compliance with the terms of Rule 12g3-2(b) prior to relying

121. Rule 12g3-2(b) under the Exchange Act, 17 C.F.R. §240.12g3-2(b) (1991).

122. *Id.* Information and documents an issuer submits pursuant to Rule 12g3-2(b) are not deemed to be ææ filed AEAE with the Commission or otherwise subject to liability under Section 18 of the Exchange Act. For this and other reasons, information submitted pursuant to Rule 12g3-2(b) is sometimes considered to be less comprehensive and reliable than information filed pursuant to Sections 13, 14 and 15 of the Exchange Act.

123. Rule 801(b)(1)(i)(B)(2); Form F-11, General Instruction I.B.(2)., *supra* note 17.

124. Proposed Rule 801(b)(1)(i)(B)(2); Form F-11, General Instruction I.B.2. Technically in order to use Rule 801 or Form F-11 a non-reporting issuer would have to determine that it were exempt pursuant to Rule 12g3-2(b) and not merely filing pursuant to that Rule. Failure to comply with all of the conditions of Rule 12g3-2(b) would call into question the availability of Rule 801 and Form F-11. The Commission does publish a list of foreign private issuers who appear to satisfy the requirements for the exemption provided by Rule 12g3-2(b). See, e.g., List of Foreign Issuers Which Have Submitted Information Required by the Exemption Relating to Certain Foreign Securities, SEC Rel. 34-28,889, [Vol. 3] Fed. Sec. L. Rep. (CCH) ¶23,317, at 17,145 (Feb. 15, 1991). As the Commission put it, however, "[i]nclusion of an issuer on the following list is not an affirmation by the Commission that the issuer has complied or is complying with all of the conditions of the exemption provided by Rule 12g-3-2(b). The list does identify those issuers that have both claimed the exemption and have submitted relatively recent information to the Commission." Id.

upon Rule 801 or filing pursuant to Form F-11. An issuer that is not already submitting documents pursuant to Rule 12g3-2(b) may initiate a claim of such exemption at the time it commences an offering in the United States under Rule 801 or at the same time it files a registration statement on Form F-11.[125]

§1.06 Accounting Standards

[1] *Under MJDS*

Although the financial statements can be prepared according to Canadian auditing and general accounting standards, all the MJSD registration forms, other than Form F-7, require that the Commission's rules on auditor independence apply to the auditor's report for the most recent fiscal year for which financial statements are included. If the registrant has previously filed with the SEC audited reports for the prior fiscal periods to which the Commission's rules on auditor independence applied, then such rules are also applicable to the prior periods.[126] The financial statements, however, otherwise can be audited under Canadian generally accepted auditing standards and can be prepared in accordance in Canadian generally accepted accounting principles. For registration on Form F-10, and only F-10, there also must be included a reconciliation to U.S. generally accepted accounting principles as specified in Item 18 of Commission Form 20-F.[127] The item 18 reconciliation will no longer be required for registration statements filed after July 1, 1993. The reconciliation required by item 18 is the so called full reconciliation that has two components. First, material variations must be quantified between Canadian GAAP and U.S. GAAP both as to the income statement and as to the balance sheet. Second, supplemental information required by U.S. GAAP must be set forth, including segmental information, pension information, and supplemental financial disclosures for oil and gas producers.[128] The accountants should consider, with respect to the financial statements included in any MJDS Form other than Form F-7, any conflict between U.S. and Canadian guidelines relating to contingencies and going concern considerations.[129] If additional comments are appropriate under U.S. guidelines and are not included in the prospectus, reference to this fact should be included as part of the legend relating to the financial statements that must be included in the prospectus.[130]

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125. Rel. 6896, *supra* note 10, at 81,720.

126. Form F-9, *supra* note 30, General Instruction III.B; Form F-10, *supra* note 7, General Instruction III.B; Form F-8, *supra* note 28, at 6136, General Instruction V-B.

127. Form F-10, *supra* note 7, Part I, Item 2.

128. See SFCL, *supra* note 84, §15.12[6][c].

129. General Instruction III.C to Forms F-9 and F-10; General Instruction V-C to Forms F-8 and F-80, *supra* notes 30 and 7.

130. *Id. See* §1.08[3] for discussion of the legend requirements.

[2] *Forms F-11 and F-12*

In connection with Forms F-11 and F-12, the issuer will not be required to comply with U.S. accounting principles and auditing standards, including the Commission's rules on auditor independence,[131] with respect to the financial statements, if any, included within the prospectus.[132] The requirements as to the need for and contents of financial statements as well as the accounting and auditing procedures are determined by the requirements of the home country.[133] Similarly, there are no financial or accounting requirements in connection with disclosure documents delivered pursuant to the Rule 801 and 802 exemptions.[134]

§1.07 Special Aspects of Exchange Offerings and a Business Combinations Under MJDS

[1] *Exchange Offers*

Forms F-9 and F-10 are all available, assuming the eligibility requirements of the specific form are met, for an exchange offer, notwithstandng the fact Form F-8 and Form F-80 are specially tailored for an èxchange offer.[135] Form F-8 may not be available for any of the following reasons:

a. The issuer had not had a class of securities listed on the Montreal, Toronto, or Vancouver (Senior Board) Stock Exchange for the required 12 month. period. It may, however, have been subject to the continuous reporting requirements of one or more of the securities commissions for three years in which event it satisfies the reporting requirements to use Form F-9 or F-10.

b. The U.S. holders hold 25% or more (forty percent or more, in the case of Form F-80) of the outstanding shares of the class of securities to whom the exchange offer is being directed. This is not a restriction on Form F-10 or F-9.

c. The issuer has a public float of outstanding equity shares of less than (CN) $75 million. This would also preclude the use of Form F-10, but it would not preclude the use of Form F-9 if the securities being offered are investment grade non-convertible debt or preferred stock.

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131. The SEC traditionally has applied its independence requirements equally to foreign and domestic accountants. E.g., Deloitte, Haskins & Sells, SEC No-Action Letter (February 14, 1983) ("non-U.S. auditor must be independent, in all substantial respects, under U.S. requirements"). The Commission's proposal to exempt foreign auditors from U.S auditor independence rules constitutes a significant reversal of longstanding Commission policy and is contrary to the approach taken in connection with Canadian financial reports for the purposes of the MJDS.

132. Form F-11, *supra* note 17, General Instruction III.B; Rel. 6896, supra note. 10, at 81,725; Form F-12, General Instructions III.B., *supra* note 18, at 6176.

133. *See infra* §1.06[2].

134. *See infra* §1.11.

135. An exchange offer is likely also to be subject to regulation under the Williams Act as a tender offer. The multijurisdictional approach to tender offers is discussed at §1.12[1].

The issuer, of course, may be eligible to use one or more of the forms or it may be ineligible to use any of them. Presumably, to the extent it has a choice, it would prefer not to use Form F-10 as that requires, until July 1, 1993, a full reconciliation of the financial statements to U.S. GAAP. For an exchange offer registered on Form F-8, F-9, or F-10, a condition to the availability of the MJDS is that the securities be offered to U.S. residents upon the same terms and conditions as offered to residents of Canada.[136] The issuer of the securities to be exchanged, in all instances, must be incorporated or organized under the laws of Canada and must be a foreign private issuer or crown corporation.[137]

[2] *Business Combination*

Securities can be offered on Form F-8 or F-10 in connection with a business combination if the issuer meets the requirements of the specific form. The form specifically tailored for business combinations is the Form F-8 and usually it would be the form used if the issuer met the eligibility requirements. The circumstances under which a Form F-10 might be available and not a Form F-8, include the following:

a. The participating companies cannot satisfy the requirement that each of them (other than small non-conforming companies) had securities listed on the Toronto, Montreal or Vancouver (Senior Board) stock exchange during the preceding twelve months, but can satisfy the Form F-10 requirement that it have been subject to the continuous reporting requirements of an appropriate Canadian regulatory authority for 36 months.

b. On completion of the business combination, U.S. holders will hold less than twenty five percent (less than forty percent in the case of Form F-80) of the class of securities being offered pursuant to the combination.[138] This is not a restriction on the use of Form F-10. In that event, however, the more stringent substantiality requirements of Form F-10 would be applicable. Form F-10 requires (CN) $360 million in market capitalization as well as (CN)$75 million in float for each participating company, except for small non-conforming companies,[139]

in contrast to the single requirement of (CN) $75 million in float for each such participating company (other than small non-conforming company) under Form F-8.

Form F-10 and Form F-8 both take into account that smaller corporations may be part of a business combination and unable to satisfy the continuous reporting and substantiality requirements. So long as the par-

136. Form F-9, *supra* note 30, General Instructions I-C.

137. Form F-9, *supra* note 30, General Instructions I-D; Form F-10, *supra* note 7, General Instructions I-C; Form F-8, *supra* note 28, General Instructions II-D.

138. Form F-8, *supra* note 28, General Instructions III-B.

139. Form F-10, *supra* note 7, General Instructions 1-A-(4)-(5).

ticipating companies meeting the requirements are contributing in the aggregate eighty percent of the assets and gross revenues on a pro forma basis, additional participants that do not meet those requirements can be added to the combination although obviously at some point if additional small non-conforming participants are added the conforming companies would no longer be contributing eighty percent of the assets and gross revenues. If the non-conforming companies contributed in excess of twenty percent of the assets or gross revenues, neither form would be available for the business combination.[140] If the conforming participants meet the eighty percent criteria, the small non-conforming participants do not have to meet the substantiality requirements of total market value and public float in the case of Form F-10 and of public float in the case of Form F-8. Similarly, under those circumstances, a small non-conforming company does not have to satisfy the twelve month listing on the Toronto, Montreal or Vancouver (Senior Board) exchanges and thirty six months of continuous regulatory disclosure otherwise necessary to use Form F-8 or the 36 months of continuous regulatory disclosure requirements of Form F-10.[141]

[3] *The Successor Corporation of a Business Combination*

In Canada, business combinations often result in the creation of a new corporation which is the issuer that would have to register the securities under the U.S. securities laws and such company obviously cannot meet either the reporting/listing requirements or the substantiality requirements of Form F-10 or Form F-8 at the time of filing.[142] The reporting and substantiality requirements however are stated so as to exclude, in addition to the small non-conforming participant, the "successor registrant."[143] Accordingly, in a business combination if the registrant is the successor company resulting from the combination, it does not have to meet the substantiality requirements or the reporting/listing requirements provided all the participating companies other than the small non-conforming participants do meet such requirements.

Similarly, if the resulting corporation is a new corporation, it could

140. *See supra* note 33.

141. Form F-10, *supra* note 7, General Instructions I-C, (3)-(5); Form F-8, *supra* note 28, General Instructions III-A, (2)-(3).

142. Under Rule 145, each solicitation of proxies relating to the shareholder vote is deemed a sale of a security that necessitating, absent an exemption, registration of the securities to be issued on consummation of the business combination, typically on Form S-4, prior to such solicitation. The Canadian authorities do not treat the solicitation of proxies as a sale of a security; hence, the applicable documentation used in Canada is pursuant to the relevant proxy solicitation rules of the appropriate agency and stock exchange. See Reproposing Release, supra note. 4, at 81,118. It is these documents rather than a Canadian prospectus that is filed as the Securities Act prospectus for the Form F-8 registration statement. Form F-8, Part I, Item 1, *supra* note 28, at 6136-6137.

143. Form F-8, *supra* note 28, General Instruction III-A (1)-2; Form F-10, *supra* note 7, General Instruction I-C (3)-(5).

not meet the continuous reporting/listing requirement for subsequent offerings until an appropriate period of time had elapsed. All the forms contain a special provision for determining whether the registrant meets the continuous reporting/listing requirement. In the case of Form F-7[144] or Form F-8,[145] the registrant must have met the listing requirement since the business combination and the time registrant has been subject to the listing/reporting requirements when added to the time each participating company to the business combination other than a small non-conforming company[146] satisfy the twelve month listing and thirty six month reporting requirements. For Form F-9[147] or F-10[148] offering being made by a successor resulting from a business combination, the registrant-successor must have been subject to appropriate reporting requirements continuously since the combination and must be in full compliance therewith, and each predecessor, other than a small non-conforming participating company, must have been subject to appropriate reporting requirements for thirty six months, tacking on for this purpose the time the registrant is subject to such requirement. Thus, if companies A and B amalgamated to form Company C and company A had been a reporting company for 5 years and company B for two years, the continuous reporting requirement would not be met until Company C has been subject to the continuous reporting requirements for at least a year. Presumably, any business combination effected under MJDS would meet these requirements provided the successor corporation was continuously listed with the appropriate exchange and/or continuously subject to regulatory reporting requirements, as appropriate for the particular form, since the business combination. These provisions ordinarily would come into play for the successor, resulting from a business combination that was not effected pursuant to the MJDS.

[4] *Other Aspects*

In an exchange offer to shareholders of another corporation (the subject corporation) or in a business combination on Form F-8, the U.S. holders in the subject corporation must hold less than twenty five percent (forty percent in the case of From F-80) of the shares of the subject corporation in an exchange offer and of the resulting corporation in a business combination. Form F-8 also requires that the issuer of the securities

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144. Form F-7, *supra* note 51, General Instruction I-C.

145. Form F-8, *supra* note 28, II-C; With respect to an exchange offer. There is no comparable provision for an offering relating to a subsequent business combination. Although the listing/reporting requirements are not applicable to a successor corporation in the business combination, this does not aid the successor corporation participating in a subsequent business combination.

146. *See supra* note 33 for a definition of a small non-conforming company, it being the same in this context as in connection with determining the availability of Form F-8 or Form F-10 in connection with a business combination.

147. Form F-9, *supra* note 30, General Instruction I-F.

148. Form F-10, *supra* note 7, General Instruction I-I.

to be acquired in an exchange offer be a Canadian foreign issuer and a Canadian corporation may not be a foreign private issuer if persons with U.S. addresses hold of record fifty percent or more of the voting securities.[149] If an exchange offer on Form F-8 takes the form of a tender offer (whether hostile or friendly), there is a presumption that the issuer of the securities to be acquired is a foreign private corporation and that U.S. holders hold less than twenty five percent of the outstanding shares of such corporation unless (1) U.S. trading volume in the class of securities being tendered for exceeded Canadian trading volume over the twelve calendar months preceding the offer; or (2) the most recent annual report or annual information form filed with an appropriate Canadian securities regulators or with the SEC indicates that U.S. holders hold twenty five percent or more of the outstanding subject class of securities; or (3) the offeror has actual knowledge that such is the fact.[150]

For a second stage business combination following an exchange offer or tender offer, there could be difficulty in meeting the public float requirements for each participating corporation in a subsequent business combination to acquire the shares not tendered in the exchange offering since, presumably, a substantial percentage of the shares of the corporation to be acquired were acquired in the exchange offer by what is now an affiliate and, therefore, not included in the public float. Form F-8 and Form F-10 both provide that if such exchange offer terminated within the past twelve months. the corporation to be acquired will be deemed to meet the participant's public float requirement if it would have satisfied such market value requirement immediately before commencement of the exchange or tender offer.[151] If the prior offer was an exchange offer, this provision is applicable only if the exchange offer was registered or would have been eligible for registration on Form 8, 9, 10, or 80; if the prior offer was a tender offer, this provision is applicable only if a Schedule 13E-4 or 14D-1F was filed or could have been filed.[152]

§1.08 Prospectus

[1] *Under MJDS*

The MJDS is premised on the assumption that there are appropriate disclosure requirements required under Canadian law that can be used as the basis for the registration statement filed with the SEC. In the case of

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149. *See supra* §1.03

150. Form F-8, *supra* note 28, General Instructions II-D, Instruction 2. Trading volumes are measured on the basis of the aggregate trading volume during the relevant period of that class of securities on the national securities exchanges and NASDAQ in the United States compared to the aggregate trading volume on securities exchanges in Canada and on the Canadian Dealing Network.

151. Form F-8, *supra* note 28, General Instructions III-A-3; Form F-10, *supra* note 7, General Instructions I-A-(5).

152. *Id.*

an offering other than an exchange offer or business combination, the appropriate document in Canada is ordinarily a prospectus. In the case of an exchange offer it is a takeover bid circular or issuer bid circular and, in the case of a business combination, an information circular.[153] The prospectus under the MJDS is based on the appropriate home jurisdiction documents. The home jurisdiction, however, depends on the nature of the offering. If the offering is a conventional offering of securities for cash, it will be processed in Canada under coordination procedures that designate one of the Commissions as the principal jurisdiction for review purposes. In that event, the prospectus will consist of the entire disclosure document(s) required to be delivered to purchasers pursuant to the laws of the principal Canadian jurisdiction. This will be true whether the offering is made on Form F-10 or F-9.[154] The principal jurisdiction concept, however, is not applicable to an exchange offer or a business combination or a rights offering. The prospectus in connection with an exchange offer is to consist of the entire disclosure document(s) used to offer securities in any Canadian jurisdiction.[155] In the case of a business combination, the prospectus consists of the disclosure documents used to solicit votes in any Canadian jurisdiction.[156] In connection with a business combination, Canadian disclosure generally is based on proxy solicitation rules rather than prospectus requirements, but the Canadian authorities changed such proxy solicitation rules to increase the disclosure required in anticipation of the adoptions of the MJDS.[157] For a rights offering, the prospectus is to consist of the entire disclosure document(s) used to offer the rights and underlying securities in any Canadian jurisdiction.[158] In all instances, the documents are to be prepared in accordance with the disclosure requirements as interpreted and applied by the home jurisdiction(s).[159]

Appropriate legend(s) must be set forth in the Prospectus, as discussed below,[160] or as required by any jurisdiction in which the offering is to be made. There also must be attached to the prospectus a list of the documents filed with the Commission as part of the registration statement.[161] The prospectus, however, does not have to include any documents incorporated by reference into home jurisdiction disclosure document(s) unless required to be delivered pursuant to the laws of the home jurisdiction.[162] If any information is incorporated by reference into the prospectus, the prospectus must set forth the name, address and telephone number of an officer of the issuer from whom copies of the incor-

153. *See* MJDS Release, *supra* note 4, at 81,870, 81,876.
154. Form F-10, *supra*, note 7, Part I, Item 1; Form F-9, *supra* note 30, Part I, Item 1.
155. Form F-10, *supra* note 7, Part I, Item 1; Form F-9, Part I, Item 1, *supra* note 30.
156. *Id.*
157. MJDS Release, *supra* note 4, at 81,870.
158. Form F-7, *supra* note 51, Part I, Item 1.
159. Part I, Item 1 of Forms F-7, F-8, F-9, F-10 and F-80.
160. *See infra* §1.08[3].
161. *See* Part I, Item 4 of Forms F-7, F-8, F-9 and F-80, +I, Item 5 of Form F-10.
162. Part I, item 1 of the appropriate form.

porated document may be obtained without charge.[163] In offerings made prior to July 1, 1993 on Form F-10, the prospectus also must include a reconciliation between U.S. GAAP and Canadian GAAP conforming to item 18 of Form 20-F.[164] This is true whether the offering is a conventional financing, a rights offering, exchange offering or business combination if registration is on Form F-10. Registration on any other form does not require such reconciliation. Presumably, the Commission expects that developments in Canadian GAAP prior to July 1, 1993 will eliminate the need for reconciliation. The Adopting Release notes that such reconciliation will not be required after that date "absent future action by the Commission to the contrary."[165]

[2] *Forms F-11 and F-12*

The disclosure requirements of Form F-11 are based almost completely upon foreign standards. The prospectus to be included within the registration statement will consist of the disclosure document or other information used to offer the securities in the issuer's home jurisdiction.[166] The "home jurisdiction" is the jurisdiction of the issuer's organization or incorporation, unless the primary market for the securities is in another country, in which event the country or the primary market is the "home jurisdiction."[167] The issuer will not be required to comply with U.S. accounting principles and auditing standards, including the Commission's rules on auditor independence, with respect to the financial statements, *if any*, included within the prospectus.[168] The prospectus would be prepared in accordance with home jurisdiction requirements, except that the issuer must include certain informational legends discussed at §1.10[3].

In an exchange offer on Form F-12, the prospectus consists of the documents required to be delivered to holders of the securities being acquired by the registrant pursuant to the laws of the home jurisdiction in which the foreign target company is organized.[169] The prospectus also must include information supplied to such holders pursuant to rules of any DOSM in any jurisdiction in which the registrant has a class of equity securities listed.[170] When securities are being registered in connection with a business combination, the prospectus includes the entire disclosure document required to be delivered to security holders pursuant to laws governing the solicitation, including rules of any DOSM upon which the

163. Form 10, *supra* note 7, Part I, Item 4,; Part I, Item 3 of Forms F-7, F-8, F-80.

164. Form F-10, *supra* note 7, Part I, item 2. *See supra* §1.06[1] for a discussion of item 18.

165. MJDS Release, *supra* note 4, at 81,868.

166. Form F-11, *supra* note 17, Item 1.

167. Form F-11, *supra* note 17, General Instruction II.A., Instruction.

168. Form F-11, *supra* note 17, General Instruction III.B; Rel. 6896, *supra* note 10, at 81,725.

169. Form F-12, *supra* note 18, Part I, Item 1.

170. *Id.*

equity securities of the participating companies are listed.[171] In general, the disclosure document must be prepared in accordance with the requirements of the foreign target company's home jurisdiction (in the case of a business combination, in accordance with the requirements governing the solicitation) as interpreted and applied by the securities commission or other regulatory authorities in such jurisdiction.[172] A registrant that is incorporated in a country different from that of the target company's may use its home country disclosure document if so permitted by the target company's home jurisdiction.[173]

[3] *The Legends*

The MJDS Forms and the proposed cross-border registration forms require that the prospectus include certain legends which are substantially the same for comparable offerings. Although the Prospectus generally follows the Canadian format and requirements, it must contain the standard Rule 423 disclosure on the cover page that the securities have not been approved or disapproved by the SEC, etc., and when appropriate the Rule 430 statement relating to a preliminary prospectus.[174] In addition, the outside front cover page (or a sticker thereto) must contain in bold-face roman type a series of informational legends, to the extent applicable, designed to alert investors to the implications of the multijurisdictional disclosure system to the following effect:[175]

1. The offering is being made by a foreign issuer that is permitted to prepare the prospectus in accordance with the disclosure requirements of its home country. Such requirements are different from those in the United States. The financial statements were prepared in accordance with foreign generally accepted accounting principles, subject to foreign auditing and auditor independence standards, and may not be comparable to financial statements of U.S. companies.

2. There may be tax consequences both in the United States and Canada because of the acquisition of the securities and their application to a citizen of the United States may not be fully described in the prospectus.

3. Enforcement by investor of civil liabilities under the federal securities laws may be adversely affected because-

The issuer is incorporated or organized under the laws of a foreign country.

Some or all the officers and directors may be residents of a foreign country.

Some or all the underwriters and experts named in the registration

171. *Id.*

172. *Id.*

173. Rel. 6897, *supra* note 11, at 81,753.

174. Part I, item 2 of the various forms other than Form F-10; Form 10, *supra* note 7, Item 3, Part I.

175. *Id.*

statement may be residents of a foreign country.

All or a substantial portion of the assets of the issuer and such persons may be located outside the United States.

4. Any legend or information required by the laws of any jurisdiction in which the securities are to be offered.

5. In the case of an exchange offer, a legend must be included to the effect that the registrant or its affiliates may bid for or make purchases of the securities under applicable Canadian law.

[4] *Exclusions from the Prospectus*

The prospectus need not include any document incorporated by reference into the Canadian disclosure document not required to be delivered to offerees or purchasers in Canada pursuant to Canadian law.[176] The U.S. prospectus can exclude any disclosure applicable solely to Canadian offerees that would not be material to offerees in the United States including, without limitation, the following:[177]

1. Any Canadian red herring legend.

2. Any discussion of Canadian tax consequences other than those material to U.S. purchasers.

3. The names of any Canadian underwriters not acting as underwriters in the United States.

4. A description of the Canadian plan of distribution (except to the extent necessary to describe material aspects of the plan of distribution in the United States).

5. A description of statutory rights under applicable Canadian securities legislation unless available to U.S. offerees or purchasers.

6. Certificates of the issuer or any underwriter.If any part of the document delivered to offerees or purchasers is not in English, it must be accompanied by an English translation.[178]

§1.09 The Registration Process

[1] *Mechanics of Registration*

The registration statement is filed under an appropriate facing page for the specific form that does not differ significantly from the typical facing page except it calls for the province or other jurisdiction of incorporation or organization, a translation of the issuer's name into English, if appropriate, the principal regulatory jurisdiction in Canada, proposed

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176. Part I, Item 1 of the various forms.

177. *Id.*

178. Form F-10, General Instruction II-J; Form F-7, General Instruction II-G; Form F-8, General Instruction IV-I; Form F-80, General Instruction IV-I; Form F-9, General Instruction II-I; Form F-12, General Instructions II-I; Form F-11, General Instructions II-G.

commencement and effective dates which take into account special procedures applicable under the MJDS, including whether securities are being registered for the shelf pursuant to procedures of the home country. Five copies of the complete registration statement and any amendments thereto, including exhibits and all other papers and documents filed as a part of the registration statement, must be filed and three additional copies and amendments thereto without exhibits must be filed with the Commission.[179] The registration statement, however, is the document required under the rules and regulations applicable in the home jurisdiction, Part I being the prospectus as described above. Part II consists of a list of the exhibits and, under the MJDS Forms F-8, F-9, F-10, and F-80, a brief description of the indemnification provisions, if any, relating to directors, officers and controlling persons of the registrant against liability arising under the Securities Act and the Commission's standard statement that in its view such provisions are against pubic policy and unenforceable.[180] The registration statement also includes undertakings, to the extent specifically required by certain forms, and the signature page.

[2] *Exhibits*

The following exhibits must be included as part of the registration statement, appropriately lettered or numbered for convenient reference:[181]

1. In the case of an exchange offer, all reports or other information that must be made publicly available in accordance with the requirements of the jurisdiction in which the subject issuer (i.e., the company whose shareholders are the subject of the offer) is incorporated and organized and a copy of all agreements relating to the proposed acquisition.

2. In the case of a business combination, all reports or other information that must be made publicly available in accordance with the requirements of the jurisdictions in which the participant companies are incorporated and organized and a copy of all agreements relating to the proposed business combination.

3. All reports or other information that under the requirements of the home jurisdiction must be made publicly available concerning the offering. The home jurisdiction for this purpose is the jurisdiction that governs the content of the prospectus as discussed above.[182]

4. Copies of any documents incorporated by reference into the registration statement and publicly available documents filed with the principal jurisdiction or any other Canadian regulatory authority concurrently

179. Form F-7, General Instruction II.C; Form F-8, General Instruction IV-C; Form F-9, General Instruction II.D; Form F-10, General Instruction II.D; Form F-11, General Instruction II.D; Form F-12, General Instruction II.C; Form F-80, General Instruction IV-C.

180. Part II of Forms F-8, F-9, and F-10.

181. Part II of the appropriate form.

182. *See supra* §1.08[1].

with the prospectus.

5. Manually signed written consents of any accountant, engineer, or appraiser, or any other expert who is named as having prepared or certified a report or valuation for use in the offering document.

6. Manually signed power of attorney of any person signing the registration statement or amendment pursuant to power of attorney, and, if relating to an officer signing on behalf of the registrant, a certified copy of a resolution of registrant's board of directors authorizing such signature.

7. A copy of any indenture relating to the registered securities.

[3] *Undertakings and Signature Page*

Part III of the MJDS Registration Statement includes an Undertaking and Consent to Service of Process. The registrant on all the MJDS registration forms other than Form F-7 undertakes to make available, in person or by telephone, representatives to respond to inquiries made by the staff and to furnish promptly upon request of the staff information relating to the securities registered or to transactions in such securities. Part III of the MJDS and Form F-12 registration forms requires the filing of a consent to service of process on Form F-X as is discussed below.

The signature page is completed in the same manner as other registration statements as to the persons required to sign, the formalities of manual signatures, powers of attorney and the like. The signature page, however, also includes, redundant in view of the Form F-X, a consent to service of process by the registrant.

[4] *Form F-X*

A manually signed Form F-X executed by the issuer, and, if applicable, the indenture trustee, must be filed separately with the Commission at the time the registration statement is filed in connection with registration on Forms F-8, F-9, F-10 and F-80, and proposed Form F-12.[183] In connection with Form F-7 relating to a rights offering, a Form F-X and consent to service of process must be filed only by a non-U.S. person acting as trustee with respect to the registered securities.[184] No Form F-X or other consent to service of process is required in connection with proposed Form F-11. The Form F-X must set forth the name of the issuer or person filing (the "Filer"), identify the filing in conjunction with which it is being filed, include the name of jurisdiction under the laws of which the Filer was organized, the full address and telephone number of the Filer, and designate and appoint a named U.S. person to serve as agent to accept service of any process, pleadings, subpoenas, or other papers relat-

183. Part III, Item 2 of the appropriate MJDS form; Form F-12, *supra* note 18, Part III, Item 1. Six copies of the form must be filed with the Commission. Form F-X, General Instruction II, [1991 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶7095 [hereinafter Form F-X].

184. Form F-7, *supra* note 51, Part III.

ing to applicable matters, with the full address and telephone number in the United States of the Agent. The Form F-X also must be signed by the Agent. Service relates to (a) any investigation or administrative proceeding conducted by the Commission; (b) any civil suit or action brought against the Filer or to which it has been joined as defendant or respondent in any appropriate court subject to the jurisdiction of a state or of the United States or of the District of Columbia or Puerto Rico arising out of or relating to, among other things, to the following: (i) An offering made by the Filer identified by the name of the form on which made and the date thereof and any purchase or sale of any security in connection therewith or (ii) as to a trustee indenture to the securities in relation to which the Filer acts as trustee. The Filer also must agree to appoint a successor agent for service of process and to file an amended Form F-X if for any reason the Agent is no longer serving in that capacity and undertakes to advise the Commission promptly in writing of any change to the Agent's name or address. The obligation to appoint a successor Agent continues until six years after the issuer ceases to report under the Exchange Act except in the case of a Form F-8 or F-80. In the case of a Form F-8 or F-80, the obligation continues for six years from the date of the latest amendment to the Form 8 or 80.[185] In the case of a signature pursuant to board resolution a certified copy of the resolution is to be filed with each copy of the Form F-X. If executed pursuant to a power of attorney, a manually signed copy of the power of attorney is to be filed with each copy of the Form F-X.

[5] *Filing and Effective Dates*

There is no specific time in relationship to the Canadian filing that the filing must be made with the SEC. It obviously behooves the issuer not to delay unduly the filing notwithstanding the fact that the filing ordinarily will be accorded a no review status since the registration statement cannot become effective until it is filed and no pre-effective selling effort can be undertaken until filed. A registration statement (and any amendment thereto) filed on any of the forms in connection with an offering being made contemporaneously in Canada and the United States becomes effective on filing with the SEC, unless, in the case of a Form F-9 or F-10 designates on the cover page that they are preliminary materials.[186] In the case of a filing on F-9 or F-10 of an offering being made in the United States only, the effective date will be any date named by the registrant that is more than seven days after the date of the filing.[187] If, in connection with such filing, Canadian authorities issue a receipt of notification or clearance prior to the end of such seven-day period, the registra-

185. Form F-X, *supra* note 183, General Instruction II.F.

186. Rule 467(a), [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶5856, at 5393.

187. *Id.* The seven days is to afford Canadian authorities an opportunity to review the filing. The filing, of course, would have to be made with the Canadian authorities or the MJDS form would not be available.

tion statement can become effective as soon as practical after written notification to the Commission of such receipt or clearance.[188] The filed documents will be given a "no review" status except for the "unusual case" in which the staff perceives a problem.[189] A registration statement on Form F-12 would become effective upon filing except if it relates to an issue of debt securities in which case it would not become effective until the issuer has complied with the U.S. [Trust Indenture Act].[190] "Moreover, the registration statement generally would not be subject to prior review by the Commission Staff."[191]

[6] *Inapplicability of Regulation C*

Regulation C, which controls the nuts and bolts relating to the filing and format of registration statements generally, is not applicable to MJDS, although selected portions have found their way into instructions included in the applicable forms and certain rules included in Regulation C are explicitly incorporated into the appropriate forms. The informational legends required as described above[192] must be in bold-face type at least as high as ten-point modern type and at least two points leaded. Each copy of the registration statement must be bound, stapled or otherwise compiled with the binding on the side or stitching margin so as to leave the reading matter legible and without stiff covers.[193] Otherwise, such nut and bolts matters are generally determined in accordance with the Canadian requirements.

[7] *Civil Liability and Other Applicable Provisions*

The civil liability provisions, including Sections 11 and 12(2) and the Section 17(a) fraud provisions of the Securities Act are applicable with respect to securities registered under the MJDS and offered in the United States. Rule 408 which requires that the registration statement include such further material information, if any, necessary to make the required

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188. *Id.*

189. MJDS Release, *supra* note 4, at 81,877. Since in most instances the registration statement becomes effective on filing, the review would be a post-effective one. Although the Commission's stop-order authority under Section 8(d) of the Exchange Act extends to registration statements that become effective, to enter the stop-order after the offering has been distributed may have little effect other than to alert purchasers that they may have an action under Section 11 or 12(2) of the Securities Act. If entered during the period during which dealers must deliver a prospectus in trading transactions pursuant to Section 4(3)(B) of the Securities Act, and Rule 174 adopted thereunder, so long as the stop-order remains in effect the period will not run and dealers will be unable to trade in the security because of the unavailability of the prospectus except in unsolicited brokerage transactions. The practical effect will be to force U.S. holders to sell the securities in Canada. See SFCL §6.12[2].

190. Rule 469, under the Securities Act [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,803.

191. Rel. 6897, *supra* note 11, at 81,756.

192. *See supra* §1.08[3].

193. Form F-10, *supra* note 7, General Instruction II-D and comparable instruction to other forms.

statements not misleading remains applicable.[194] The Rules imposing limitations on the underwriters and in some instances dealers while the issuer is in registration relating to market reports and recommendations continue in force,[195] as does Rule 174 relating to the delivery of a prospectus in the trading market. The safe-harbor rules relating to projections and oil and gas supplemental information apply to MJDS offerings if otherwise applicable.[196]

Some concern was expressed that to the extent that Canadian disclosure differs from U.S. standards that courts may use the failure to comply with U.S. standards as a basis for imposing liability. The Commission declined to adopt a rule dealing with this situation, but has attempted to alleviate these concerns, stating:[197]

> By adopting the MJDS, the Commission in essence would adopt as its own requirements the disclosure requirements of Canadian forms. The effect would be the same as if the Commission had set forth each Canadian requirement within the MJDS forms.

§ 1.10 Exchange Act Registration and Reporting

[1] *Section 15(d) Reporting Companies*

Section 15(d) requires an issuer that has registered securities under the Securities Act to file annual and periodic reports specified by Section 13(a) of the Exchange Act. A Canadian foreign private issuer registering securities on a MJDS form and other foreign private issuers registering securities on the MJDS forms or F-11 or Form F-12, therefore, would ordinarily become subject to the reporting requirements of the Exchange Act.[198] An issuer registering securities on proposed Forms F-11[199] and F-12,[200] however, is exempted from the continuous reporting obligations of Section 15(d) of the Exchange Act.[201] The MJDS does not contain an outright exemption from Section 15(d) for MJDS registrants, but provides that If at the time of filing of a Form F-7, F-8 or F-80 registrant was relying on the Rule 12g3-2(b) exemption from registration under the Exchange Act, no reporting obligation will arise under Section 15(d).[202]

194. General Instructions II-B of the relevant form.

195. Rule 138, [1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶5713A; Rule 139, [1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶5713B, at 5060.

196. Rule 175, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶5736, at 5183-5185.

197. Reproposing Release, *supra* note 4, at 81,130.

198. *See generally* SFCL, *supra* note 84, § 3.11.

199. Proposed Rule 12h-5, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,803, at 81,736.

200. Proposed Rule 12h-4, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,803, at 81,771.

201. *See supra* § 1.04[2].

202. Rule 12h-4. It is not unlikely that a similar qualification will be applicable to Form F-11 and F-12 registrants. Rule 12h-4 was proposed in connection with the Form F-12 proposal without such qualification and then adopted three days later as part of the MJDS

There is no Section 15(d) exemption for registrants on Forms F-9 or F-10. In the event Section 15(d) reporting requirements are triggered by the registration of securities on one of the MJDS forms, registrant can elect to satisfy the reporting requirements by filing an annual report on Form 40-F provided such reporting requirements arise solely by reason of such registration.[203] Form 40-F, which is a wrap around of the home jurisdiction report, is discussed at §1.10[3]. If the issuer's securities are listed or are to be listed on a U.S. stock exchange or are quoted or are to be quoted on NASDAQ, then the issuer will have to register the class of securities under Section 12 of the Exchange Act on Form 20-F (or, if eligible, Form 40-F) and will thereafter be subject to the reporting requirements of Section 13(a) of the Exchange Act which include, among other things, require the filing of an annual report on Form F-20 (or, if eligible, Form 40F).[204]

[2] *Exchange Act Registration*

Section 12(g) of the Exchange Act requires an issuer with total assets of in excess of $5 million to register any class of equity securities if there are 500 or more holders of record of that class of security.[205] A foreign private issuer with less than $5 million in total assets or with fewer than 300 U.S. residents as shareholders in a class of equity securities, is exempt from registration under the Exchange Act if its securities are not listed in the United States and not traded on NASDAQ.[206] There is also an exemption for foreign private issuers under Rule 12g3-2(b) for issuers conforming with the requirements of the exemption which generally requires the filing with the SEC of documents and releases material to shareholders that are required by the regulators (including stock exchanges) in the issuer's home country. The offering by a foreign private issuer in the United States on an MJDS form or the cross-border registration forms, other than on Form F-7 or proposed Form F-11, which necessarily are to existing shareholders, will increase the number of U.S. residents that are shareholders and, hence, the possibility that the issuer will have in excess of 300 U.S. residents as shareholders in a class of equity securities and can no longer rely on the Section 12g3-2(a) exemption from registration under the Exchange Act. The foreign private issuer under such circumstances can, if it chooses, rely on the Section 12g3-2(b) exemption by making the required filings with the SEC necessary to obtain such exemption. An issuer reporting on Form 40-F to satisfy their Section

Release with this qualification as it applies to the relevant MJDS Forms. It may be that the qualification reflects some last minute fine tuning of the provision.

203. Form 40-F, General Instructions, A(1) [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,812 [hereinafter Form 40-F].

204. *See* SFCL, *supra* note 84, § 15.13 for discussion of Form 20-F registration and reporting.

205. *See* SFCL, *supra* note 84, § 3.03 for discussion of Exchange Act registration.

206. Rule 12g3-2(a), *supra* note 121.

15(d) reporting obligation can satisfy the 12g3-2(b) exemption requirements simultaneously by indicating on the cover page of the Forms 40-F and 6-K that the information is being filed for both purposes and including its filing number for the exemption.[207]

[3] *Form 40-F*

The MJDS introduces a new Form 40-F for registration and reporting by Canadian foreign private issuers which for eligible Canadian issuers permits them in several instances to register under the Exchange Act and/or to comply with the reporting requirements under the Exchange Act essentially by a wrap-around filing with the SEC of the documents they are required to file with the appropriate Canadian regulatory (including any stock exchange on which they may have securities listed) authorities. In the event Section 15(d) reporting requirements are triggered by the registration of securities on one of the MJDS forms,[208] registrant can elect to satisfy the reporting requirements by filing an annual report on Form 40-F provided such reporting requirements are solely by reason of such registration.[209] Form 40-F also can be used for reporting by Canadian issuers pursuant to Section 13(a) or Section 15(d) of the Exchange Act that have not previously registered securities under one of the MJDS Securities Act registration forms or to register securities pursuant to Section 12(b) or 12(g) provided the issuer is a Canadian foreign issuer and meets the following requirements:[210]

1. The issuer has been subject to Canadian reporting requirements for at least 36 months (12 months in the case of a crown corporation) and is currently in compliance.

2. If the filing relates to convertible securities of an issuer that would be eligible to use Form F-9 for the registration of such securities,[211] the market value of the outstanding equity shares of the registrant must be (CN) $180 million or more and the market value of the public float of such equity shares must be (CN) $75 million.

3. If the filing relates to non-convertible securities of an issuer that would be eligible to use Form F-9 for the registration of such securities, there are no threshold that must be met as to the market value of the outstanding equity shares or public float.[212]

4. In all other cases, the market value of the outstanding equity shares of the registrant must be (CN) $360 million and the market value of the public float in such securities must be (CN) $75 million.

Form 40-F, in the case of registration, requires the filing of all infor-

207. Facing Page of Form 40-F, *supra* note 203.
208. *See supra* § 1.10[1].
209. Form 40-F, *supra* note 203, General Instructions, A(1).
210. *Id.*, General Instructions A(2).
211. *See supra* § 1.04[1].
212. *Id.*

mation material to an investment decision that the Registrant, since the beginning of its last full fiscal year, (i) made or was required to make public pursuant to the law of any Canadian jurisdiction; (ii) filed or was required to file with a stock exchange on which its securities are traded and which was made public by such exchange; or (iii) distributed or was required to distribute to its security holders.[213] The registration statement on Form 40-F must also include that portion of the issuer's home jurisdiction reports, forms or listing application that describes the securities to be registered.[214] A list of the documents constituting the registration statement is to be filed as an Exhibit to the registration statement.

If the Form 40-F is being filed as an annual report, registrant must file the annual information form required under Canadian law, its audited annual financial statements and accompanying management's discussion and analysis.[215]

In any Form 40-F filed prior to July 1, 1993, with limited exceptions noted below, the financial statements, other than interim statements, must include a reconciliation to U.S. GAAP as required by Item 17 of Form 20-F.[216] Such reconciliations are not required in the case of securities that would be eligible for registration on Form F-9[217] or if the form is being filed solely because of reporting obligations arising under Section 15(d) because of the prior registration of securities on Form F-7, F-8, F-9 or F-80. In all instances, the Commission's rules on auditor independence are applicable except as to certain prior fiscal years.[218] Registration statements and annual reports filed on Form 40-F have to be in the English language.[219] A consent to service of process on Form F-X must be filed as part of the Form 40-F and an undertaking to cooperate with the SEC.[220]

Registrants filing annual reports on Form 40-F, must file periodically on Form 6-K all other information (i.e., not included in its annual report on Form 40-F) material to an investment decision that registrant i) makes public pursuant to the law of the jurisdiction of its domicile, (ii) filed or was required to file with a stock exchange on which its securities are traded, or (iii) distributed or was required to distribute to its security holders.[221]

Documents filed on Form 40-F to satisfy reporting obligations must be filed with the Commission the same day they are filed with the Cana-

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213. Form 40-F, *supra* note 203, General Instructions B-(1).

214. *Id.* General Instructions B-(2).

215. *Id.* General Instructions B-(3).

216. *Id.*, General Instructions, C-(2). On the difference between Item 17 reconciliation and Item 18, *see* SFCL, *supra* note 84, §15.13[1][c].

217. *See supra* §1.04[1].

218. Form 40-F, *supra* note 203, General Instructions, C-(1). The requirements are comparable in this respect to those relating to the filing on the MJDS Securities Act registration forms. *See* § 1.06[1].

219. *Id.*, General Instructions B-(4).

220. *See supra* § 1.09[4] for discussion of Form F-X.

221. Form 40-F, General Instructions B-(3), *supra* note 203.

dian securities regulatory authority.[222] Documents required to be filed on by Form 6-K must be furnished to the Commission promptly after they are made public, filed or distributed.[223]

The issuer reporting annually on Form 40-F, like other foreign issuers reporting on Form 20-F, need only comply with Form 6-K for interim reporting.[224]

§1.11 Exemption from Registration For Cross Border Rights, Exchange Offerings and Business Combinations

[1] *Rule 801*

Section 3(b) of the Securities Act authorizes the Commission to exempt securities from the registration requirements if the aggregate amount of the offering does not exceed $5 million.[225] The Commission has proposed Rule 801 under Section 3(b) to exempt securities issuable upon the exercise of rights granted by qualified foreign private issuers. The Rule provides a limited alternative to registration on Form F-11.[226] The aggregate offering price of securities offered to U.S. security holders can not exceed $5 million.[227] The non-U.S. portion of the offering and offerings pursuant to other exemptions or to registration need not be included in the $5 million amount.[228] The rights themselves may not be transferable except in accordance with Regulation S[229] under the Securities Act.[230] Rule 801 does not impose any specific disclosure requirements but requires the issuer to provide U.S. holders with the same information as that provided to offerees in the issuer's home jurisdiction.[231] The Rule

222. MJDS Release, *supra* note 4, at 81,873.

223. *Id.*

224. Rule 13a-16 and 15d-16 as amended by Sec. Act Rel. No. 6902, *supra* note 4.

225. 11 U.S.C.A. § 77c(b) (1981).

226. *See supra* § 1.04[2].

227. The Rule provides that the "aggregate offering price of securities subject to outstanding offers made to offerees that are U.S. holders in connection with each rights offering made in reliance on this § 230.801 shall not exceed $5,000,000." Rule 801(b)(4), *supra* note 16 at 81,768. The "aggregate offering price" is the total gross sales price to be received by the issuer for issuance of its securities upon exercise of the related rights. Rule 801(c)(1). For purposes of the calculation it is assumed that all rights granted as part of the rights offering are exercised. Rel. 6896, *supra* note 10, at 81,722.

228. Rule 801, *supra* note 16, Preliminary note 8.

229. Regulation S, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶5921.

230. Rule 801(b)(3)(i)(C)(2), *supra* note 16, at 81,732.

231. *Id.*, Proposed Rule 801(b)(3)(ii). "Home jurisdiction" is the country of the issuer's organization or incorporation, unless the primary market (as defined) for the issuer's equity securities is in another country, Rule 801(c)(6), in which event the country of the primary market for the issuer's listed securities is the "home jurisdiction." *Id.* If information regarding the offering is published in the home jurisdiction instead of being delivered to offerees, the issuer may publish substantially equivalent information in English in a publication of general circulation in the United States. Rule 801(b)(3)(ii). Alternatively, the issuer may deliver a written copy of the home jurisdiction publication to offerees in the United States. *Id.*

generally is not available for rights offerings by investment companies registered or required to register under the Investment Company Act of 1940.[232] The exemption provided by Rule 801 would apply only to transactions that satisfy a number of requirements ("Common Eligibility Requirements") that also determine a registrant's eligibility to use Form F-11.[233] The Com-mon Eligibility Requirements provide generally that the issuer must be a foreign private issuer and either reporting under the Exchange Act or exempt from such reporting by reason of Rule 12g3-2(b).[234] If the issuer is not a reporting issuer, its securities must be listed or quoted on a DOSM AND either have maintained such listing or quotation for the immediately preceding 36 months OR have a public float of not less than $75 million.[235]

Rights offerings made pursuant to Rule 801 are subject to the antifraud, civil liability and other provisions of the federal securities laws.[236] The Commission indicated, however, that it will enter an order exempting such offerings from the antimanipulative provisions of Rule 10b-6, 10b-7 and 10b-8.[237]

[2] *Rule 802*

Rule 802 exempts any exchange offer for a class of securities of a foreign private issuer if it satisfies the conditions of the Rule,[238] irrespective of whether the offeror issuer is a foreign or U.S. issuer.[239] The exemptive rule would also apply to an exchange of securities for securities of a foreign private issuer in connection with a business combination whether or not the acquiring issuer is a foreign or U.S. issuer.[240] The aggregate dollar amount of securities being offered in the exchange offer or business combination in the United States may not exceed $5 million under the proposed rule.[241] The Rule is equally available for debt and equity securities.[242] The exchange offer (and securities issued in the business combina-

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232. Rule 801, *supra* note 16, Preliminary note 8. Foreign issuers able to make public offerings in the U.S. pursuant to Rule 6c-9 or an exemptive order under the Investment Company Act would be eligible to use Form F-3, *supra* note 10, at 81,721-81,722.

233. *See supra* §1.04[2].

234. 17 C.F.R. §240.12g3-2(b). Rule 12g3-2(b), known as the "information supplying exemption," exempts certain securities issued by foreign private issuers from the registration requirements of Section 12(g) of the Exchange Act. To qualify for the exemption provided by Rule 12g3-2(b), the issuer must periodically supply certain information to the Commission. *See* SFCL, *supra*, note 84, at § 15.13[3][a].

235. Rule 801(b)(1)(B)(2)(i)-(ii), *supra* note 16, at 81,731.

236. Rule 801, *supra* note 16, Preliminary Note 1.

237. Rel. 6896, *supra* note 10, at 81,728.

238. Rule 802(b), *supra* note 16, at 81,765.

239. Rel. 6897, *supra* note 11, at 81,752.

240. A "business combination" is a statutory amalgamation, merger, arrangement or other reorganization requiring the vote of shareholders of one or more of the participating companies. Rule 802(a)(6), *supra* note 16, at 81,768.

241. Rule 802(c)(1), *supra* note 16, at 81,768.

242. Rel. 6897, *supra* note 11, at 81,752.

tion) must be for a class of securities of a "foreign private issuer."[243]

The exemption does not apply to transactions by an investment company registered or required to be registered under the Investment Company Act,[244] except for companies that have the benefit of an exemptive order under such Act or that may rely on Rule 6c-9.[245] The exemption provided by Rule 802 as indicated is only available if the aggregate dollar amount of securities being offered in the United States in the exchange offer or business combination does not exceed $5 million.[246] Recognizing the limitations of this approach (the parameters of which were fixed by Section 3(b) of the Securities Act), the Commission requested comment as to whether the ceiling is "so low as to neutralize the exemption's usefulness by enough offerors to warrant the rule-making effort on both the federal and state levels?"[247] Offers and sales made outside the United States would not be included in calculating the $5 million threshold nor would registered domestic offerings or domestic offerings made pursuant to other exemptions be integrated even if made contemporaneously with the offering under Rule 802.[248]

The exemption does not apply to transactions by an investment company registered or required to be registered under the Investment Company Act,[249] except for companies that have the benefit of an exemptive order under such Act or that may rely on Rule 6c-9.[250] The exemption provided by Rule 802 as indicated is only available if the aggregate dollar amount of securities being offered in the United States in the exchange offer or business combination does not exceed $5 million.[251] Recognizing the limitations of this approach (the parameters of which were fixed by Section 3(b) of the Securities Act), the Commission requested comment as to whether the ceiling is "so low as to neutralize the exemption's usefulness by enough offerors to warrant the rule-making effort on both the federal and state levels?"[252] Offers and sales made outside the United States would not be included in calculating the $5 million threshold nor

243. Rule 802(b), *supra* note 16, at 81,768.

244. Rule 802, Preliminary note 7, *supra* note 16, at 81,767.

245. Rel. 6897, *supra* note 11, at 81,751.

246. Rule 802(b), Rule 802(a)(7), *supra* note 16, at 81,767-81,768. This limitation applies to the total dollar amount the offeror proposes to issue upon exchange for securities of a single class held by U.S. security holders, assuming all of the subject securities held in the U.S. are exchanged. Rule 802(a)(7). The amount of the securities being offered is to be calculated based upon the market value of the securities held by U.S. holders. *Id.*

247. Release 6897, *supra* note 11, at 81,752.

248. Rule 802, *supra* note 16, Preliminary Note 8.

249. *Id.*, Preliminary Note 7.

250. Rel. 6897, *supra* note 11, at 81,751.

251. Rule 802(b), Rule 802(a)(7), *supra* note 16, at 81,767-81,768. This limitation applies to the total dollar amount the offeror proposes to issue upon exchange for securities of a single class held by U.S. security holders, assuming all of the subject securities held in the U.S. are exchanged. Rule 802(a)(7). The amount of the securities being offered is to be calculated based upon the market value of the securities held by U.S. holders. *Id.*

252. Release 6897, *supra* note 11, at 81,752.

would registered domestic offerings or domestic offerings made pursuant to other exemptions be integrated even if made contemporaneously with the offering under Rule 802.[253]

The exchange offer or business combination must permit all U.S. holders to participate on terms no less favorable than those offered to other holders.[254] If, however, the law of a particular state requires the registration or qualification of securities sold therein and the offeror does not register or qualify the offering in that state, the offeror must offer security holders in such state a cash alternative if cash has been offered in any other jurisdiction; if cash has not been so offered, the offeror is not be required to extend a cash alternative in that state.[255] In this event, the offeror may exclude the security holders in such state and still claim Rule 802 as to security holders elsewhere. Aside from this exception, the transaction must permit all U.S. holders to participate on terms no less favorable than those offered to other holders.[256]

The offeror must furnish U.S. holders the same information as that provided to offerees in the home jurisdiction simultaneously with or as soon as practicable after such information is made available in the home jurisdiction.[257] Rule 802 provides that with respect to an exchange offer of securities made in reliance upon Rule 802, "home jurisdiction" means the country of the foreign target company's organization, incorporation or chartering.[258] Thus the disclosure requirements are established by a reference to the foreign target company's home country.[259] The supervisory agencies of the target company's jurisdiction would establish the applicable disclosure standards and, as "a general rule, the Commission would not expect the document submitted or filed with the Commission to be reviewed by the staff; such review, if any, would be left to the foreign target company's jurisdiction."[260] Rule 802 is somewhat ambiguous as to which jurisdiction governs the disclosure standards in the case of business combinations. Rule 802(e) provides that U.S. holders must be provided with the same information as that provided to offerees in the home jurisdiction of the issuer, and Rule 802(a)(4) providing a definition of "home jurisdiction" only with respect to an exchange offer. The Release does not

253. Rule 802, Preliminary Note 8, *supra* note 16, at 2683-3.

254. Rule 802(c)(2), *supra* note 16, at 2687-7.

255. *Id.*

256. *Id.*

257. Rule 802(e), *supra* note 16, at 2684. If information regarding the offering is published in a newspaper in the home jurisdiction the issuer may publish substantially equivalent information in a publication of general circulation in the United States or deliver copies of the home jurisdiction instead of being delivered, publication to offerees in the United States. The information delivered to U.S. holders must be in the English language. *Id.*

258. Rule 802(a)(4), *supra* note 16, at 2683-7. *Cf.* Rule 801 (c)(6), *supra* note 16, at 2683-7, defining "home jurisdiction" for purposes of the rights offering exemption generally as the country of the issuer's organization or incorporation.

259. Rel. 6897, supra note 11, at 81,752-81,753.

260. *Id.* at 81,745.

distinguish in this regard between exchange offers and business combinations, but states simply that disclosure provided to U.S. security holders would be governed by the requirements of the foreign target company's home country.[261] The disclosure documents must include legends, to the extent applicable, as specified in Rule 802(d). The legends are similar to those required in connection with registration on Form F-12.[262]

§1.12 Tender Offers and the MJDS

[1] *Under MJDS*

The MJDS is necessary with respect to third party tender offers directed to U.S. shareholders of a Canadian foreign private issuer to the extent there is subject matter jurisdiction under the Williams Act's tender offer provisions. Section 14(e) of the Exchange Act, the anti-fraud tender offer provision, is applicable to all tender offers. For the most part the filing requirements and substantive regulation relating to a third party tender offer is found in Regulation 14D and those relating to issuer tender offers in Rule 13e-4. There are, however, some provisions of Regulation 14E that, although taking the form of defining fraudulent practices, impose substantive regulation (e.g., the period a tender offer must remain open under Rule 14e-1) on all tender offers.

The acquisition of shares in Canadian companies through a takeover bid or exchange offer is regulated in Canada at both the federal and the provincial levels.[263] A bidder must comply with the securities acts of each province in which one or more target shareholders resides and with the federal or provincial corporate statute under which the target company is incorporated. Ontario and Quebec laws apply to most takeovers and exchange offers conducted in Canada since must Canadian corporations with a significant number of shareholders are likely to have shareholders in these provinces.

Canada's federal and provincial takeover laws impose on third-party bidders, target management, and issuers engaged in a self-tenders detailed disclosure requirements that closely resemble those prescribed by the Exchange Act.[264] There are counterparts to the Schedules 14D-1, 14D-9, and the 13E-4. In addition, in connection with an exchange offer, as in the United States, prospectus filing requirements and prospectus level disclosure relating to the securities being offered must be complied

261. Rel. 6897, supra note 11, at 81,752-81,753.

262. *See supra* § 1.08[3].

263. The description of the regulation of takeover bids in Canada is based upon the Proposing Release. Securities. Act Release No. 6841, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) +84,432, at 80,294-80,296 (July 24, 1989) [hereinafter the "Proposing Release"]. The Proposing Release sets forth an extensive comparative analysis of takeover/tender offer regulation in Canada that provides much of the rationalization for the SEC's willingness to accept Canadian regulation absent a predominant U.S. shareholder interest.

264. On comparison of Canadian and U.S. tender offer regulation see Proposing Release, *Id.* at 80,294-296.

with. There are also Canadian substantive provisions regulating tender offers such as the period that the offer must remain open, making the offer to all shareholders, pro-rata taking in the case of partial offers, and withdrawal rights that are similar to those applicable in the United States. The Canadian requirements relating to the delivery of tender offer materials (takeover bid circulares) are similar to those under the Exchange Act.

The basic eligibility requirements for a third party or self tender offer under the MJDS in terms of the place of organization and Canadian character of the corporation is the same as under the MJDS for Securities Act registration-the target (or the issuer in the case of a self-tender) must be a foreign private issuer organized under the laws of Canada or a Canadian province or territory that is not a company registered or required to register under the Investment Company Act.[265] Relevant definitions such as foreign private issuer and U.S. holder are the same as those applicable to Securities Act registration.[266] The MJDS is applicable to tender offers only if U.S. holders hold of record less than forty percent of the class of securities that is the subject of the tender offer[267] and that the offer be extended to U.S. holders upon terms and conditions not less favorable than those extended to any other security holder.[268] The less than 40% U.S. holder requirement is determined at the end of the issuer's last quarter or, if such quarter terminated within 60 days of the filing date, as of the end of the issuer's preceding quarter.[269] If the bid consists of an exchange offer, and if the securities offered are registered on any MJDS Form other than Form F-80, the U.S. holders in the target company must be less than 25%.[270] Accordingly, in an exchange offer, the securities must be registered on Form F-80 or a non-MJDS form, or limited to a target with less than twenty five percent U.S. holders notwithstanding the less than forty percent threshold of Schedules 13E-4F or 14D-1F.

An issuer or third-party bidder competing with an initial offer launched under the MJDS might be unable to use the MJDS for its bid if as a result of arbitrage activities the record ownership of U.S. holders increased above the forty percent threshold since commencement of the initial bid. The MJDS rules take this into account by providing that the

265. General Instructions I.A , I.C of Schedule 13E-4F, General Instructions I.A. and I.C., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶23,708 [hereinafter *Schedule 13E-4F*]; Schedule 14D-1F, General Instructions I.A. and I.C., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶24,284G [hereinafter *Schedule 14D-1F*].

266. *Id.* General Instruction 1-A and Instructions 1 and 2. *See supra* § 1.02 for the definition of U.S. holder and §1.03 for the definition of foreign private issuer.

267. General Instructions I.A of Schedules 13E-4F, 14D-1F, *supra* note 265.

268. *Id.* at 17,304 and 17,752. Although not an eligibility requirement, in the case of a third party bid, the target necessarily is registered under the Exchange Act as otherwise there would be no subject matter jurisdiction and no need to comply with any SEC filing requirements.

269. General Instructions I.A of Schedules 13E-4F, 14D-1F, *supra* note 265.

270. *See supra* § 1.04[1].

date of the first bid made under the MJDS is also the date for determining the U.S. holders for all subsequent, competing bids.[271]

The MJDS creates a safe harbor that affords third-party bidders the benefit of a presumption that U.S. holders hold less than forty percent of the subject class of securities and that the issuer is a foreign private issuer, unless aggregate trading volume in the prior twelve months in the United States exceeded that in Canada, or unless information to the contrary appears in the most recent annual report or information statement filed by the issuer with Canadian (Ontario, Quebec, British Columbia, Quebec, or, if the issuer is not a reporting company in any of them, any other Canadian securities regulator) or U.S. securities regulators, or the bidder has actual knowledge that US. holders own forty percent or more of such securities.[272]

The MJDS includes counterpart forms to the relevant tender offer forms; to wit, Schedules 13E-4F, 14D-1F, and 14D-9F. In each instance in which the filing of a Schedule is required under the Exchange Act, the counterpart MJDS Schedule is to be filed. The MJDS Schedules are basically a wrap around of the documents required to be filed with the appropriate Canadian authorities, specified undertakings, a signature page and a Form F-X consent to service of process.[273] The home jurisdiction documents filed with the SEC and delivered to U.S. residents must be supplemented by specified informational legends on the outside front cover page in bold type designed to make the U.S. resident aware that (1) that the tender offer is being made in compliance with the disclosure requirements of the target's home country (Canada); (2) that those requirements are different from those of the United States; (3) financial statements may not be comparable to those prepared by U.S. companies; (4) enforcement of civil liabilities under the federal securities laws may be adversely affected; (5) the bidder may bid for the issuer's securities while the tender offer is in progress as permitted by Canadian law.[274]

Under the MJDS, not only is Canadian disclosure and review accepted, but substantially all of the Canadian substantive regulation (including such matters as dissemination of the tender offer materials, the period during which the offer must remain open, withdrawal rights, etc.) rather than U.S. regulation is applicable.[275] There must, however, be compliance with the Canadian regulation since the MJDS schedules are avail-

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271. Schedule 14D-1F, General Instructions I.A, Instruction 4, Schedule 13E-4F, General Instructions I.A, Instruction 4, *supra* note 265.

272. General Instructions I.A, Instruction 3 of Schedules 13E-4F, 14D-1F, *supra* note 265. Trading volume in the U.S. is based on the aggregate trading on national securities exchanges and NASDAQ and that in Canada on Canadian securities exchanges and the Canadian Dealing Network. *Id.*

273. *See id.* Parts I-IV of the appropriate schedules.

274. *See* Part II, Item 2 of Schedules 13E-4F, 14D-1F, 14D-9F, *supra* note 265.

275. General Instructions III.A of Schedules 13E-4F, 14D-1F. Rules 13e-4(g), Rule 14d-1(b).

able and such substantive regulation is waived only if "the tender offer is subject to, and the bidder complies with the laws, regulations and policies of Canada and/or any of its provinces or territories governing the conduct of the offer. . . ."[276] Assuming compliance with the applicable Canadian law and the appropriate MJDS forms and regulations relating, for example, to a third party tender offer, such compliance is deemed to satisfy the requirements imposed by Sections 14(d)(1) through (d)(7) of the Exchange Act, Regulation 14D and Schedules 14D-1 and 14D-9 thereunder, and Rule 14e-1 (which provides for the period of time a tender offer must remain open).[277] Rule 14e-2(c) provides that filing a Schedule 14D-9F that includes the appropriate Canadian documents satisfies the requirement of the Rule that the target or any of its officers or directors file a Schedule 14D-9.

Section 14(e) (the general tender offer anti-fraud provision), Rule 14e-3 (relating to insider trading based on knowledge of a prospective bid), Section 10(b) and the rules adopted thereunder,[278] and Section 18 of the Exchange Act, however, continue to apply to the tender offer.[279] Schedule 13D, which must be filed with the Commission and sent to the issuer and any exchange on which the security is listed if one makes an acquisition of shares part of a class of equity securities registered under the Exchange Act that will bring the acquire (including for this purpose a group acting together) to a 5%, or more beneficial ownership threshold in that class of security,[280] is not affected in any way by the MJDS.

[2] *Cross Border Tender Offers and the Williams Act*

In numerous cases involving tender offers for predominantly foreign companies, the question arises as to the appropriate treatment of the U.S. shareholders of the foreign target company. Foreign bidders have frequently excluded U.S. holders from tender offers for foreign companies on grounds that the costs of complying with the Williams Act outweighed the advantages of including the U.S. holders in the offer.[281] The Commission has proposed amendments to its rules under the Williams Act designed to facilitate the inclusion of U.S. shareholders in predominantly

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276. *Id.* Rule 13e-4(g), Rule 14d-1(b).

277. Rule 14d-1(b), *supra* note 275.

278. The Commission, however, adopted a number of exemptions to Rules 10b-6 and 10b-13 to accommodate Canadian practice. *See* Order of Exemption from Provisions of Rule 10b-6 and 10b-13 under the Securities Exchange Act of 1934 for Canadian Multijurisdictional Disclosure Systems, Exchange Act Release No. 29355, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,813 (June 21, 1991).

279. General Instructions I.B and I.C of Schedules 13E-4F, 14D-1F, *supra* note 265.

280. *See* SFCL *supra* note 84 at § 13.21.

281. The Commission has observed that the Williams Act and rules thereunder do not require foreign bidders to extend offers to target shareholders residing in the United States unless a foreign offeror uses the jurisdictional means of the United States, in which case the tender offer generally must be made to U.S. shareholders on the same terms as other target shareholders. Proposing Release, *supra* note 4, at 80,299, n. 151.

foreign tender offers. Under proposed amendments to Rule 14d-1, any tender offer for securities of a foreign private issuer would be exempt from the disclosure and substantive provisions of the Williams Act if ten percent or less of the outstanding class of securities that was the subject of the tender offer were held by U.S. holders other than 10% holders.[282] The exemption would be available to both foreign and U.S. bidders if the target company is a foreign private issuer and the other conditions of the Rule are met.[283] Specifically, the tender offer would be exempt from the requirements of Section 14(d)(1) through 14(d)(7) of the Williams Act, Regulation 14D thereunder and Rule 14e-1.[284] To qualify for the exemption, U.S. holders must be afforded the opportunity to participate on terms no less favorable than those offered to other holders of the same class, with certain exceptions.[285] If the subject securities are registered under Section 12 of the Exchange Act, the disclosure document required to be furnished to holders must be submitted to the Commission on Form 14D1C and disseminated to U.S. holders in accordance with the target company's home jurisdiction's laws.[286] Disclosure required to be furnished to U.S. holders generally is governed by the jurisdiction of the foreign target company.[287] The exemption provided by Rule 14d-1(c) would not be available to investment companies registered or required to be registered under the Investment Company Act.

282. Rule 14d-(1)c, *supra* note 265, at 17,739. The Commission has proposed revisions to Regulation S-K, Form 20-F, and Rule 12g3-2(b) to require foreign private issuers to disclose U.S. ownership of their equity securities. Proposed Amendments to Regulation S-K, Proposed Form 40-F, and Rule 12g3-2; Proposed New Forms for Furnishing Materials Pursuant to Rule 12g3-2(b), [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) +84,805 (June 6, 1991). These revisions will facilitate determination of the 10% threshold. In addition, a bidder may conclusively presume that U.S. ownership is below the 10% threshold if the company is not a reporting company or submitting documents pursuant to Rule 12g3-2(b) unless the bidder has knowledge to the contrary. Release 6897, *supra* note 11, at 81,748. *Cf.* Rule 14d-1(b), which exempts qualifying tender offers for a class of securities of Canadian issuers made under MJDS in accordance with Canadian law where U.S. holders hold less than 40% of the subject securities.

283. Rel. 6897, *supra* note 11, at 81,747. This position leads to the somewhat anomalous result of allowing U.S. bidders to make tender offers to U.S. investors in accordance with foreign regulations. *Id.* The basis of this position is the "potential regulatory inequality that could result if U.S. companies were required to comply with multiple regulatory schemes. . ." *Id.*

284. Rule 14d-1(c), *supra* note 265, 17,739. The tender offer would also be exempt from Schedule 14D-1 and 14D-9. The Rule 14e-3 tender offer provisions would continue to apply. Rel. 6897, *supra* note 11, at 81,747.

285. *Id.* at Rule 14d-1(c)(1). The exceptions relate to impediments to extending an offer in a particular state due to state securities law requirements. Also, a bidder is not required to extend to U.S. holders alternative non-cash consideration the purpose of which in the home jurisdiction is income tax deferral. Rule 14d-1(c)(1)(iii).

286. *Id.* at Rule 14d-1(c)(2). The materials furnished to the Commission would not be deemed to be "filed" with the Commission and the offeror would not be subject to liability under Section 18 of the Exchange Act.

287. Rel. 6897, *supra* note 11, at 81,749.

The Commission also proposed comparable changes to Rule 13e-4[288] to exempt from the requirements thereof any issuer tender offer, including an exchange offer, by a foreign private issuer if ten percent or less of the outstanding class of securities is held by U.S. holders, other than U.S. holders of more than ten percent of the class. The exemption is conditioned on eligibility requirements substantially similar to those set forth in the proposed amendments to Rule 14d-1.

[3] *Tender Offers for U. K. Companies*

The Commission also proposed entering an exemptive order to address takeover bids for U.K. companies that involve U.S. jurisdiction. Takeover bids in the U.K. are subject to the City Code on Take-Overs and Mergers (the "City Code"), which is administered by the Panel on Takeovers and Mergers.[289] Cross-border takeover bids for U.K. companies with U.S. shareholders have presented a number of issues under the Williams Act, many of which were seen as impediments to the orderly progress of such offers. The SEC proposes to codify various accommodations it has previously made in this area.[290] These accommodations involve withdrawal rights, the all-holders rule, public announcements of the offer, guaranteed deliveries, disclosure documents, and Rule 10b-13.[291] As proposed, the exemptive order would extend to tender offers for U.K. companies that are "foreign private issuers."[292] The order would grant certain limited exemptions from the requirements of the Williams Act.[293]

§1.13 Rule 10b-6 and 10b-13

Rules 10b-6 under the Exchange Act precludes a bidder in an exchange offer from purchasing its own securities and Rule 10b-13 under the Exchange Act generally precludes a bidder from purchasing securities subject to the tender offer outside of the tender offer.[294] Bidders in Canada may make purchases under limited circumstances during a tender offer.[295] The Commission concurrently with the adoption of MJDS entered an order of exemption from provisions of Rules 10b-6 and 10b-13 that permit the offeror to purchase securities of the target company (and in the case of an exchange offer, the offered securities) outside of the tender offer if the appropriate disclosure document discloses the intent to make (or the possibility of) such purchases and discloses in the United States the same information the bidder is required to disclose or other-

288. Rule 13e-4, 17 C.F.R. §240.13e-4.

289. *See generally* International Capital Markets and Securities Regulation [hereinafter "ICMSR"] §1.08[6][b].

290. Rel. 6897, *supra* note 11, at 81,761.

291. *Id.* at 81-761-81,765.

292. *Id.* at 81,761.

293. *Id.*

294. *See* SFCL, *supra* note 84, at § 13.28[1][f].

295. *See* MJDS Release, *supra* note 4, at 81,876.

wise discloses concerning the actual purchases under Canadian law.[296] Canadian law permits purchases from the third day following the date of the bid until its termination provided (1) such purchases do not exceed five percent of the shares outstanding on the date of the bid, (2) the intention to make such purchases is disclosed in the bid circular, and (3) a press release is made and filed with the relevant exchange or regulatory authority reporting such pertinent information relating to such purchases at the close of each day on which securities have been purchased.[297]

§1.14 Coordination of State Registration with the MJDS

[1] *Introduction*

Chairman Breeden and members of the Commission's staff have expressed concern that blue sky laws may prove an impediment to the implementation of a multijurisdictional disclosure system.[298] Such views of alarm were expressed notwithstanding the adoption of a resolution by members of NASAA supporting multi-jurisdictional disclosure and the adoption by the Board of Directors of NASAA of model rules for state implementation of the Multi-Jurisdictional Disclosure System ("MJDS").[299]

This concern, however, may be somewhat exaggerated. If one assumes a firmly underwritten offering to be made by a Canadian issuer registering an offering on one of the MJDS forms through dealers licensed in the states of the United States in which the offering is to be made, the general registration pattern under the blue sky laws is as follows:

There are no registration or filing requirements in the District of Columbia or Hawaii. The District of Columbia does not register securities and Hawaii exempts from securities registration securities registered with the SEC.[300]

There are no registration or significant filing requirements in New York provided the securities are not real estate syndication securities. New York registers only intrastate offerings[301] and offerings of real estate securities.[302] A licensed New York dealer will have to file a Further State Notice, a routine and minimum filing, with the Secretary of State in connection with the offering.[303]

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296. "Order of Exemption from Provisions of Rule 10b-6 and 10b-13 under the Securities Exchange Act of 1934 for Canadian Multijurisdictional Disclosure Systems," Exchange Act Release No. 29355, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,813 (June 21, 1991).

297. *See* MJDS Release, *supra* note 4, at 81,876, *citing* OSA §93(3) and Reg. §169, QSA §142.

298. *See* 22 Sec. Reg. & Law Rep. (BNA) 1315 (Sept. 14, 1990).

299. *See infra* §1.14[3].

300. Haw. §485-5(15), Blue Sky L. Rep. (CCH) ¶20,105.

301. N.Y. Gen. Bus. Law ch. 20, art. 23-A , §359-ff, Blue Sky L. Rep. (CCH) ¶42,131.

302. N.Y. Gen. Bus. Law ch. 20, art 23-A, §352-e, Blue Sky L. Rep. (CCH) ¶42,106.

303. N.Y. Gen. Bus. Corp. Law ch. 20, art. 23-A, §359-e(1.)(b), Blue Sky L. Rep.

Georgia exempts (Coordination Exemption) an offering which is registered under the Securities Act or qualified under Regulation A. In order to obtain the Coordination Exemption, however, a Notice of Intention to sell must be filed accompanied by the documents filed with the SEC, a consent to service of process, and payment of a filing fee.[304] Louisiana has a coordination exemption that is substantially identical to that of Georgia. A Notice of Intention to Sell must be filed on Form U-1.[305] Florida has a similar procedure available for securities registered with the SEC, but in Florida, rather than being an exemption, it constitutes registration by notification.[306] In Florida, the procedure is not available for securities offered at $5 or less per share unless the securities are listed on a national securities exchange, or are quoted or authorized for quotation on NASDAQ.[307] Pennsylvania has an exemption for securities registered with the SEC: however, it is available to companies that are reporting companies under the Exchange Act.[308]

In the states of Arizona, North Dakota, Oregon, Vermont, and, if offered for less than $5 a share, Florida, there are no provisions for registration by coordination and ordinarily the securities have to be registered by qualification. Oregon does have registration by filing which is a registration by coordination procedure limited to seasoned issuers.[309] The procedure is available only for securities of issuers meeting a number of criteria, including a three year reporting history with the SEC. Surprisingly, the states that do not have registration by coordination have taken the lead in attempting to accommodate MJDS. See discussion at §1.14[3].

The remaining jurisdictions have a version of the Uniform Act's registration by coordination provisions.

[2] *Registration by Coordination*

The registration by coordination provisions accommodate concurrent state and federal securities registration by (1) simplifying the registration process in the state, and (2) providing a procedure that, if complied with, permits the registration statement to become effective in all of the states upon giving notice to the state administrator that the registration statement filed with the SEC has become effective. Although the statutory waiting period prior to effectiveness under the Securities Act is twenty days from the date the registration statement is filed, under MJDS registration is effective on filing with the SEC unless the registrant requests that the effective date be deferred. The Uniform Act procedure relating

(CCH) ¶42,128).

304. Ga., §10-5-9(5), Blue Sky L. Rep. (CCH) ¶18,109.

305. La., §51:709(5), Blue Sky L. Rep. (CCH) ¶28,139.

306. Florida, §517.082, Blue Sky L. Rep. (CCH) ¶17,108A.

307. Florida, §517.802(3), Blue Sky L. Rep. (CCH) ¶17,108A.

308. Pa., §203(i), Blue Sky L. Rep. (CCH) ¶48,113.

309. Oregon, §59.065, Blue Sky L. Rep. (CCH) ¶47,107. *See* SFCL §14.02[2] for a description of the blue-chip exemption.

to concurrent effectiveness requires the following:[310]

(1) That the appropriate documents be on file with the State Administrator for at least ten calendar days prior to the effective date. In practice, unfortunately, many states take a longer period to review a filing and by one means or another keep the registration statement from becoming effective if the review has not been completed at the time the SEC registration statement is expected to become effective.

(2) That all amendments to the SEC registration statement be filed with the State Administrator no later than the first business day after the day they are forwarded to or filed with the SEC (whichever first occurs). The Form U-1 undertaking relating to amendments to the SEC registration statement tracks this provision except it provides for a filing no later than the second business day.

(3) That the maximum and proposed minimum offering price and the maximum underwriting discounts (or commissions) be on file for at least two days before the effective date.

(4) That the State Administrator be promptly notified by telephone or telegram of the date and time the SEC registration statement became effective and the content of the price amendment.

(5) That the price amendment, if not previously filed, be promptly filed thereafter as a post-effective amendment.

A number of states have provided different periods from the above as to the initial filing date, requiring in some instances a shorter period and in other instances a longer period. The shorter period, of course, is more convenient from the applicant's standpoint and the longer periods could adversely affect the efficiency with which the offering can be completed. States with a shorter period are Alabama (five days), Colorado (five days, registration by filing), Connecticut (fifteen days), Tennessee (five days), and Virginia (three days after the filing of the registration statement and all amendments other than the price amendment). States with a longer period are Iowa (twenty days), Michigan (twenty days), Minnesota (twenty days), Missouri (fifteen days), New Hampshire (twenty days), Ohio (fifteen days), South Dakota (twenty days). Michigan also requires that all amendments to the SEC registration statement other than the price amendment be on file for ten days before the effective date.

Several states in addition to requiring a minimum period of time during which the registration statement be on file require that it be filed within a certain number of days of the filing with the SEC. States in this category include California (five business days), Maine (ten days), Nevada (five days), New Jersey (ten days), New Mexico (five days), Ohio (five days), Rhode Island (ten days). The failure to comply with this requirement can increase significantly the period of time the registration statement must be on file prior to the effective date. In view of the fact

310. Uniform Securities Act §303(c).

that the MJDS registration statement becomes effective on filing with the SEC, it may be advisable to reverse the usual order and file with the states sufficiently in advance of the SEC filing to permit the registration statement to become effective with the states when it is filed with the SEC. Otherwise, it may be necessary to defer SEC effectiveness until sufficient time has elapsed for registration to become effective in the states in which the offering is to be made. Section 303(c) of the Uniform Act does provide that, if the SEC registration statement becomes effective before all of the state conditions are satisfied, the registration statement becomes effective automatically when all of such conditions are satisfied.

[3] *NASAA Model MJDS Rule*

The NASAA Model Rules[311] seeks to deal with the timing problem by providing that a registration filed with the SEC on an MJDS Form need be on file with the State Administrator for only seven days prior to the effective date rather than ten.[312] This is based on the understanding that seven days is the normal review period in Canada for offerings in this category.[313] Several states have taken action to accommodate MJDS. Surprisingly, the four states that do not have registration by coordination (Arizona, North Dakota, Vermont and Oregon) have made a special effort to accommodate MJDS. Arizona provides that an offering that has become effective with the SEC on Form F-7, F-8, F-9, F-10 is exempt from registration provided a disclosure document is filed with the Administrator at least seven days before the offering is made and that a non-refundable fee of one-tenth of one percent of the offering price of the securities offered in Arizona is paid with a minimum fee of $200 and a maximum of $2,000.[314] Oregon will permit an MJDS registration statement to become effective when the SEC registration statement becomes effective, provided it has been on file for at least seven days.[315] Vermont promises to expedite such filings and will attempt to register such offerings within seven days of filing, but does not guarantee that it will be able to do so.[316] North Dakota has announced that it believes it can expedite such registration and that no amendments to its regulations are necessary for this purpose.[317] Eleven states (Alaska,[318] California,[319] Idaho,[320] Kansas,[321]

311. Model Rules For State Implementation of the Multi-Jurisdictional Disclosure System (adopted Aug. 30, 1990) [hereinafter the MJDS Model Rules], NASAA Reports (CCH) ¶2371.

312. *Id.* at MJDS Model Rule No. 1.

313. *Id.* at Comment to MJDS Model Rule No. 1.

314. Az., Reg. R14-4-135, Blue Sky L. Rep. (CCH) ¶9541.

315. Ore., Rule 441-65-035, Blue Sky Rep. (CCH) ¶47,559A.

316. Vt., Policy Statement (9-12-91), Blue Sky Law Rep. (CCH) ¶58,417.

317. N. D., Letter (June, 1991), Blue Sky Law Rep. (CCH) ¶44,520.

318. Alaska, Policy Statement (2-26-92), Blue Sky L. Rep. (CCH) ¶8562.

319. Calif., Rel. No. 90-C, Blue Sky Law Rep. (CCH) ¶12,623.

320. Idaho, Policy Statement 89-5 (12-11-89), Blue Sky L. Rep. (CCH) ¶27,488.

321. Kansas, Order (7-25-91), Blue Sky Law Rep. (CCH) ¶26,514.

Kentucky,[322] Montana,[323] North Carolina,[324] Rhode Island,[325] South Carolina,[326] Texas,[327] and Washington[328]) have reduced the number of days prior to the effective date that the registration statement must be on file to seven days and Nebraska has promised to attempt to complete its review within seven days.[329] Massachusetts[330] will permit MJDS registration statements to become effective when declared effective by the SEC without regard to how long it has been on file with the state.

The assumption of the Model Rule was that by filing concurrently with the Canadian authorities, the SEC, and the states, effectiveness in Canada would trigger effectiveness with the SEC which would trigger effectiveness with the states in which a timely filing was made. But the Model Rule was adopted in several states while the MJDS was proposed and before finally adopted by the SEC. The MJDS as adopted contemplates that registration with the SEC will be effective on filing.[331] This suggests that the filing should be made with the states prior to the filing with the SEC and, in any event, concurrently with the Canadian filing. The comments to the Model Rule suggests that states may want to waive the ten-day period entirely, particularly in connection with exchange offers on Form F-8, to provide more flexibility and to permit effectiveness on filing. This appears particularly appropriate in view of the SEC's decision to not only grant "no review" status but to permit the registration statement to become effective on filing.

[4] *Financial Statements and the MJDS*

The MJDS registration forms permit the financial statements to be prepared in accordance with Canadian general accepted accounting principles.[332] For registration filed on Form F-10, if the filing is made prior to July 1, 1993 it also must include a reconciliation to U.S. generally accepted accounting principles as specified in Item 18 of Commission Form 20-F.[333] The reconciliation required by Item 18 is the so called full reconciliation that has two components. First, material variations must be quantified between Canadian GAAP and U.S. GAAP both as to the income statement and as to the balance sheet. Second, supplemental information required by U.S. GAAP must be set forth, including segmental information, pension information, and supplemental financial disclosures

322. Ky., Policy Statement (April 4, 1991), Blue Sky Law Rep. (CCH) ¶27,580.
323. Mont., Policy Statement (1-16-92), Blue Sky L. Rep. (CCH) ¶36,521.
324. N.C., Policy Statement (4-8-91), Blue Sky L. Rep. (CCH) ¶43,513.
325. R.I., Order (4-10-91), Blue Sky L. Rep. (CCH) ¶50,507.
326. So. Carolina, Statement of Policy (8-12-91), Blue Sky Law Rep. (CCH) ¶51,570.
327. Texas, Reg. §113.13, Blue Sky L. Rep. (CCH) ¶55,590C.
328. Wash, WAC 460-11A-010, Blue Sky Law Rep. (CCH) ¶61,535.
329. Neb., Interpretative Opinion No. 19 (7-1-91), Blue Sky Law Rep. (CCH) ¶37,471.
330. Mass., Reg. §13.302, Blue Sky L. Rep. (CCH) ¶31,462.
331. *See, supra* §1.09[5].
332. *See supra* §1.06[1].
333. Form F-10, *supra* note 7, Part I, Item 2.

for oil and gas producers.[334]

The Model Rules provide that with respect to registration statements filed on one of the MJDS forms that financial statements and financial information that have been prepared in accordance with Canadian generally accepted accounting principles may be included in the registration state.[335] Reconciliation to U.S. GAAP is not required. The Model Rule was drafted in a fashion that this would be true with respect to registration on Form F-10 if the Commission should decide not to require reconciliation with U.S. GAAP. The Model Rule was proposed before the SEC adopted the MJDS in final form and assumed that the Commission might be persuaded to not require such reconciliation. The Commission did modify the original proposal so as to no longer require reconciliation after July 1, 1993. Such reconciliation will be required, therefore, until July 1, 1993 in order to register the securities with the SEC and presumably will, therefore, be included in any document filed in connection with state registration.[336]

[5] *Rights Offerings and the MJDS*

Form F-7 relating to rights offerings is more significant on the federal level than the state level, since the Uniform Act states have an exemption for rights offerings that would generally be available provided no commissions other than a standby commission are paid and the rights are not exercisable for more than ninety days.[337] The Uniform Act includes a provision[338] under which, if one of the conditions of the exemption for rights offerings is not complied with, the issuer can file a notice with the Administrator setting forth the terms of the proposed rights offering and an exemption is available if the Administrator does not disallow it within five days after the filing. The MJDS Rules[339] provides that, in lieu of this filing, the Administrator shall accept a copy of the registration statement filed with the SEC on Form F-7.

[6] *Secondary Trading and the MJDS*

A real barrier to any foreign offering in the United States is the necessity for finding a secondary trading exemption for the resale of those securities. Several states have the Uniform Act provision under which the

334. *See supra* §1.06[1].

335. MJDS Model Rules, *supra* note 311, Rule 2.

336. In an attempt to anticipate what the SEC might do with respect to reconciliation, the MJDS Model Rules seem to require that the securities offered pursuant to Form F-10 include a prospectus in which the SEC has not required a reconciliation to U.S. GAAP. The comments to Rule 2, however, make clear that this language was intended to accommodate the situation should the SEC decide, as it has not done, to eliminate reconciliation to U.S. GAAP.

337. *See* Uniform Act (1985), §402(b)(11).

338. Uniform Securities Act (1985), §402(b)(11)(B).

339. MJDS Model Rules, *supra* note 311, Rule No. 3.

registration statement covering the primary distribution registers effectively for one year all outstanding securities of the same class. The immediate secondary trading problem, therefore, is likely to arise in the jurisdictions in which the primary offering was not made. A number of states have secondary trading exemptions for securities as to which appropriate information is included in a recognized securities manual such as Moody's and Standard and Poor's. Since foreign issuers are less likely to be included in a recognized securities manual and Moody's Manual for international securities is not universally accepted by the states, this may pose a problem for several foreign issuers.[340] The Model MJDS Rules provide a secondary trading exemption (an exemption for non-issuer transactions) of securities previously registered on Form F-8, F-9, or F-10.[341] The comments to the Rule suggest that it is within the discretion of each jurisdiction as to whether to include a secondary trading exemption for securities registered on Form F-7. The implication of the comment is that, although holders of the Canadian securities should not be denied the benefit of the rights offering, if the securities were not previously entitled to a secondary trading exemption (which, presumably, means the securities were sold to residents of the state in violation of the state's securities act), the F-7 should not legitimize further trading in the security. In the latter event, residents of the state would have to look to a foreign (presumably Canadian) market for the resale of the security or a state in the United States in which there is an exemption for such resales.

The states that have adopted the Model Rule relating to registration of the primary distribution generally have not adopted a specific exemption for secondary trading. See §1.14[3]. Massachusetts has adopted a non-issuer transaction exemptions for offerings registered with the SEC on Forms F-8, F-9, and F-10.[342] In Arizona, all offerings registered with the SEC on Forms F-7, F-8, F-9, or F-10 are exempt from registration, presumably, including non-issuer transactions.[343]

[7] *Filing of Documents and Sales Literature*

The Uniform Act specifies the documents that are to be filed with the State, which, however, are free to modify them by Rule.[344] Although the statutory filing requirements for registration by coordination remain, for all practical purposes they have been superseded by the uniform form U-1.[345] In addition, most of the non-coordination states have either adopted or accept Form U-1. The qualification states also have detailed requirements as to the contents of a prospectus, but generally will accept the SEC prospectus in lieu thereof. The application and prospectus re-

340. *See* Blue Sky L. Rep. (CCH) ¶6301.
341. MJDS Model Rules, *supra* note 311, Rule No. 4.
342. Mass., Section 14.402(B)(13)(j), Blue Sky L. Rep. (CCH) ¶31,472.
343. *See supra* §1.14[3].
344. Uniform Securities Act (1985), §303.
345. *See* NASAA Reports (CCH) ¶5011.

quirements of the states in which registration by qualification is necessary and the coordination states is essentially the same. The principal difference is that the qualification non-coordination states do not have a procedure that assures that the registration will become effective concurrently with the SEC registration statement.

The Model MJDS Rules do not address the documents to be filed with the states. The Form U-1 requires the filing of a copy of the registration statement filed with the SEC and two copies of the prospectus.[346] The only additional Form U-1 document that has to be filed that is not an exhibit to the SEC registration statement is the specimen certificate and an appropriate consent to service of process. The SEC's MJDS forms primarily rely on filing as Exhibits the documents filed with the Canadian authorities;[347] hence, there is no assurance that the specific document called for by Form U-1 will be part of the SEC filing. Because of the basic nature of the SEC exhibits (underwriting agreements, articles, by-laws etc.) it is likely that if not part of the Canadian and SEC filings such documents will be readily available. For the most part, therefore, the documents required for the state filings will entail producing extra copies of such documents and including them as part of the state filing.

The Form U-1 also requires the filing with the state of all sales literature intended to be used in the state. A number of states require that sales literature be filed a specified number of days prior to use. There are generally exceptions for tombstone advertisements.

[8] *Form F-X and Consent to Service of Process*

The MJDS requires the filing of a Form F-X which includes a consent to service of process executed by the issuer, appointment of a U.S. person as agent for service of process, a consent to service of an administrative subpoena and an undertaking to assist the SEC with administrative investigations.[348] The consent to service of process relates, among other things, to any civil suit brought in any appropriate court in any place subject to the jurisdiction of any state or the United States arising out of an offering registered on one of the MJDS forms. This appears to be broad enough to cover actions based on state laws, but, nonetheless states will expect compliance with their requirements relating to the filing of a consent to service of process. A Form U-1, in the states that follow the Uniform Act, can be filed by the issuer or by a broker-dealer registered in the state.[349] Presumably, in most instances the registration statements relating to a MJDS offering will be filed in each state by a registered dealer who will file a consent to service of process with respect to claims arising under the state securities laws to the extent it has not al-

346. *Id.*
347. *See supra* §1.09[2].
348. *See supra* §1.09[4].
349. Uniform Securities Act (1985), §305(a).

ready done so. The Uniform Act requires the issuer to file a consent to service of process only if it is the applicant and/or if the offering is being made by the underwriter as its agent which typically would involve a best efforts underwriting. The Uniform Act also has a long arm provision to the effect that anyone engaging in activities in the state that violate the securities act or give rise to a claim thereunder shall be deemed to have appointed the Administrator as its agent for service.[350]

[9] *Merit Requirements and the MJDS*

The conditions to the availability of the MJDS registration forms under the Securities Act make it unlikely that most of the state blue sky merit provisions will be applicable, since, such provisions are applicable primarily to companies in the promotional or development stage. Some conditions to registration under state blue sky law, however, are of general application; e.g., restrictions on underwriting compensation and/or offering expenses; the issuance of warrants to underwriters; non-voting common stock, issuance of senior securities, and others.[351] It remains to be seen as to the extent to which states will insist on applying these conditions to registration to offerings made pursuant to the MJDS.

[10] *The Exemption Alternative*

There is an alternative route available for many foreign issuers and that is to be listed on the New York or American (or, in some states, other) Stock Exchange or to be quoted on NASDAQ/NMS. Such listing or approval for listing on notice of issuance or designation on NASDAQ/NMS will exempt an offering of securities from registration under the securities laws of all but a few of the jurisdictions that register securities.[352] In order to become listed on an Exchange or quoted on NASDAQ, however, an issuer must register a class of securities under the Exchange Act. The MJDS introduces a new Form 40-F, a multi-purpose form for registration and reporting by certain Canadian issuers under the Exchange Act. Form 40-F can be used by certain Canadian issuers to register securities under the Exchange Act and for such issuers provides a convenient means of obtaining access to trading on NASDAQ (or on a U.S. exchange).[353] Form 40-F requires for registration and for reporting pursuant to Section 13(a) of the Exchange Act the filing of documents the issuer is required to file with the appropriate Canadian regulatory authorities (including any stock exchange on which they may have securities listed) and the financial statements, in most instances, until July 1, 1993 will have to be reconciled to U.S. GAAP in accordance with the requirements of Item 17 of Form 20-F. Item 17 requires a quantitative reconciliation to U.S.

350. *Id.* at §708(c).

351. For a list of NASAA Statements of Policy and adoptions by jurisdictions, *see* Blue Sky L. Rep. (CCH) ¶6211.

352. *See* Blue Sky L. Rep. (CCH) ¶6401.

353. *See supra* §1.10[3].

GAAP, but not the full reconciliation required by item 18 of Form 10-F.[354] Except for such financial statement requirements, Form 40-F registration and reporting essentially is no more burdensome than complying with the Section 12g3-2(b) exemption which permits trading in the United States but not on NASDAQ or on an exchange. Canadian issuers that are eligible to do so can use Form 40-F to "upgrade" to Exchange Act registration and move off the NASD Electronic Bulletin Board onto NASDAQ and designation on the National Market System (NMS), assuming they meet the NMS qualifications.[355] By listing on an exchange or being approved for NASDAQ/NMS quotation they will have also obtained an exemption from registration securities of the same class as those listed or designated for listing on notice of issuance, warrants to purchase such security, and securities senior or substantially equal to the listed or quoted class of security in a substantial number of states.[356]

Several states have a so-called blue-chip exemption. The blue-chip exemption is for securities senior to or on parity with a class of securities registered by the issuer under the Exchange Act for the three preceding years; the issuer has not defaulted on principal, interest, dividend, sinking fund installments, rentals under long-term leases; the issuer had consolidated net income after taxes and before extraordinary items of at least $1 million in each of four of its last five fiscal years, including its last fiscal year; its stock, assuming a stock offering, is owned by at least 1,200 persons, there are outstanding at least 750,000 shares with a market capitalization of $3.75 million; provisions relating to voting rights; and other provisions if the security offered is a debt security. An issuer not organized under the laws of the United States or a state of the United States must appoint an agent to accept service of process in the United States and set forth the name and address of such agent in the prospectus. In many instances, a security exempt under the blue-chip exemption, if quoted on NASDAQ as a designated NMS security, would be exempt under the NASDAQ/NMS exemption. If the issuer cannot meet the three year or other blue-chip prerequisites, the NASDAQ/NMS or listed security exemption may be an appropriate alternative.

§1.15 NASD Corporate Financing Rule and the MJDS

The NASD also regulates underwriting compensation and a number of aspects of underwriter warrants.[357] The NASD regulation could impede an offering to a greater extent than state regulation of commissions as several aspects of the NASD standards/guidelines are vague and often undeterminable. The NASD has requested comments from its members on a proposal that would exempt offerings of Canadian issuers filed on Form F-9 or F-10 from filing the registration statement for review for

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354. *Id.*
355. For the NMS qualifications, *see* NASD Manual (CCH) ¶¶1808-1813.
356. Blue Sky L. Rep. (CCH) ¶6401.
357. *See* NASD Manual (CCH) ¶2151.02.

fairness and reasonableness of underwriting compensation by its Corporate Financing Department.[358] Registration statements on Form F-8 or F7 would have to be filed if otherwise required to be filed.

§1.16 The Canadian Multijurisdictional Disclosure System

[1] *Introduction*

In June 1991, the Canadian Securities Administrators ("CSA") adopted a new regulatory system designed to serve as the counterpart to the multijurisdictional disclosure system concurrently adopted in the United States ("MJDS" or "U.S. MJDS").[359] The Canadian multijurisdictional disclosure system ("CMJDS") is similar to the U.S. MJDS with some variation to accommodate differences in U.S. and Canadian procedures and institutional arrangements. For a discussion of MJDS, see §§1.01-1.13.

The CMJDS also extends to tender offers and exchange offers for U.S. issuers where Canadian residents hold less than 40% of the class of securities that is the subject of the bid.[360] Finally, the system enables qualifying U.S. companies that otherwise would be subject to Canadian continuous disclosure, proxy, and insider reporting rules to observe, instead, corresponding U.S. requirements.[361] U.S. issuers and others using the CMJDS will remain subject to civil, criminal and administrative liability under Canadian law.

In 1990, the Canadian Securities Administrators, an organization of securities regulators from all but two of the Canadian provinces and territories, released Draft National Policy Statement No. 45.[362] CSA and the U.S. Securities and Exchange Commission ("SEC") adopted the two measures in tandem in June 1991.

The CMJDS allows a U.S. issuer to distribute the following types of securities in Canada primarily on the basis of U.S. disclosure documents: non-convertible debt and preferred securities with an "Approved Rat-

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358. NASD, Notice to Members No. 91-34 (June, 1991). The discussion of the proposal suggests that the exemption is applicable to any registration on Form F-10. The language of the proposal specifically exempts such registration only if the securities are registered for the shelf pursuant to Rule 415.

359. Multijurisdictional Disclosure System, National Policy Statement No. 45 [hereinafter, "Policy Statement"]. The Policy Statement has been published as Appendix C to the MJDS Release, *see supra* note 4. National Policy Statements are applicable to Alberta, British Columbia, Manitoba New Brunswick, Nova Scotia, Ontario, Prince Edward Island, Quebec, Saskatchewan, and the Yukon Territory, and inapplicable to Newfoundland and the Northwest Territories. *See* National Policy Statement No. 1, [Vol. 3] Can. Sec. L. Rep. (CCH) ¶470-001, at 57,525.

360. Policy Statement, *supra* note 359, §4.2(7).

361. *Id.* at §1.

362. Draft National Policy Statement No. 45, [Vol. 1] Can. Sec. L. Rep. (CCH) ¶10-200, at 4186 (Nov. 1990) [hereinafter "Draft Policy Statement"]. *See also Canadian Regulators Issue Proposal for Cross-Border Offerings by U.S. Firms*, 22 Sec. Reg. L. Rep. (BNA) 1608 (Nov. 16, 1990).

ing"[363] (hereafter, "investment grade debt and preferred shares"); certain convertible investment grade debt and preferred shares; other securities, if the issuer meets a "substantiality" requirement, described below; and rights offerings by qualifying U.S. issuers to their Canadian shareholders.[364] Both the issuer and selling security holders may use the system.[365]

Generally, the U.S. disclosure requirements that would apply if the offering were being made in the United States govern the disclosure document to be used for the Canadian offering. The prospectus generally is not required to comply with the form or content provisions of Canadian law. For offerings in Quebec, however, the issuer is required to file both English and French versions of the prospectus.[366] The issuer may present its financial statements in accordance with U.S. requirements, except in offerings of certain non-investment grade securities in which case the issuer must reconcile its statements to Canadian accounting principles or International Accounting Standards.[367] In the case of concurrent U.S. and Canadian offerings, the registrant initially files the registration statement with the SEC which has primary responsibility for reviewing the disclosure document.[368] If the issuer uses CMJDS to offer securities solely in Canada, the disclosure document, which is still based on U.S. disclosure requirements, is filed with and reviewed by the jurisdiction in Canada which is supervising the offering.

[2] *Definitions and Key Terms*

The definitions under the CMJDS are similar and in some instances substantially identical with those used in the MJDS. The definitions set forth in CMJDS include (but are not limited to) the following:

An "affiliate" with respect to an issuer, is "a person or company who directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the issuer."[369] This is the U.S. definition of an affiliate,[370] the Canadian authorities proposing to in-

363. The Draft Policy Statement referred to this category of securities as "investment grade" securities. The Policy Statement as adopted changed the composition of this category and re-designated it as "Debt or Preferred Shares Having an Approved Rating". Policy Statement, *supra* note 359, §§3.2, 2(4). The terms "investment grade securities" and "securities having an Approved Rating" (the latter defined *infra* §1.16[2]) are used herein interchangeably.

364. Generally, MJDS is not available for offerings of derivative securities, such as stock index warrants, currency warrants and debt the interest on which is based on a stock index. The system is available for warrants, options, rights and convertible securities in cases where the issuer of the underlying security is eligible to distribute such securities pursuant to CMJDS. Draft Policy Statement, *supra* note 362, at § 3.1.

365. *Id.*

366. *Id.* at § 3.8.

367. *Id.* at § 3.10.

368. *Id.* at § 3.8(1).

369. Policy Statement, *supra* note 359, at § 2(1).

370. Rule 405, 17 C.F.R. § 230.405.

corporate it into the CMJDS just as the SEC has incorporated the Canadian definition of an affiliate into the U.S. MJDS.[371]

The "applicable Canadian securities legislation" is the securities legislation of each province and territory in which securities are offered, or a bid is made, under the Policy Statement.[372] Similarly, the "applicable securities regulatory authority" means the securities authority in each Canadian province and territory in which securities are offered or a bid is made under the Policy Statement.[373]

"Approved rating" when used in relation to debt or preferred shares, means securities that have received a provisional rating by the Canadian Bond Rating Service Inc., Dominion Bond Rating Service Limited, Moody's Investors Service, Inc. or Standard and Poor's Corporation in one of the generic categories set forth in Section 2(4) of the Policy Statement.[374] This definition is the same as that in CSA's shelf prospectus and delayed pricing system,[375] a recently adopted system that corresponds roughly to SEC Rules 415 and 430A.

"A business combination means a statutory merger or consolidation or similar plan or acquisition requiring the vote or consent of security holders of a company or person, in which securities of such company or person or another company or person held by such security holders will become or be exchanged for securities of another company or person."[376]

"Canadian GAAP" refers to the accounting principles generally accepted in Canada; where the Handbook of the Canadian Institute of Chartered Accountants recommends a principle, "Canadian GAAP" as used in the Policy Statement means such principle.[377]

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371. *See* Multijurisdictional Disclosure and Modification to the Current Registration and Reporting System for Canadian Issuers, Sec. Act. Rel. No. 6879, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,701, at 81,113 n. 9 (Nov. 2, 1990) [hereinafter "U.S. Re-Proposing Release"]. The U.S. MJDS employed the Canadian definition so that "Canadian registrants can identify their affiliates under the definition they are accustomed to applying." *Id.*

372. Policy Statement, *supra* note 359, at § 2(2).

373. *Id.* at § 2(3).

374. *Id.* at §2(4). The ratings are, with respect to debt securities, AAA, AA, A or BB, Standard & Poors Corporation; Aaa, Aa, A or Baa, Moody's Investors Service, Inc.; AAA, AA, A or BBB, Dominion Bond Rating Service Limited; A , A , A or B , C.B.R.S. Inc. The Policy Statement gives corresponding ratings for preferred shares. Draft National Policy Statement No. 45 only recognized the top three ratings as constituting investment grade. Subsequently, the Canadian regulatory authorities recognized the fourth highest rating category as signifying investment grade. Policy Statement, *supra* note 359, at §2(4). In response, the SEC changed the requirements of Form F-9-a registration form for offerings of investment grade debt and preferred stock by "substantial" Canadian issuers upon adoption generally to allow registration of securities having a rating in one of the four highest categories. U.S. MJDS Release, *supra* note 4, at 81,868.

375. National Policy Statement No. 44, [Vol. 3] Can. Sec. L. Rep. (CCH) at 57,725-2.

376. Policy Statement, *supra* note 359, at §2(8).

377. *Id.* at §2(9). In Staff Accounting Communique No. 1, the staff of the OSC noted that the regulations under the Act define generally accepted accounting principles as the principles set forth in the Handbook of the Canadian Institute of Chartered Accountants.

CMJDS, as proposed by CSA, generally is available to any "foreign issuer" organized under the laws of the United States or any state or territory of the United States or of the District of Columbia. "Foreign issuer" is defined in Section 2(17) of the Policy Statement to exclude nominally foreign issuers that, in reality, are principally owned by Canadians or located in Canada.[378]

"Independent underwriter" with respect to the application of the Policy Statement in a province or territory, means a dealer that is not the issuer and in respect of which "the issuer is not a related party or related issuer or connected party or connected issuer or, where the dealer is not a registrant in such province or territory, would not be a connected party or connected issuer if the dealer were a registrant."[379]

"International Accounting Standards" refers to the accounting principles issued by the International Accounting Standards Committee.[380]

"Market value" with respect to a class of securities, is the aggregate market value of the securities, calculated by using the price at which the securities were last sold in the principal market for the securities as of a

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[Vol. 3] Can. Sec. L. Rep. (CCH) ¶474-001, at 59,001. In referring to financial statements filed with the OSC, in Staff Accounting Communique No. 1, the staff also pointed out that it "would expect reporting issuers to comply with the CICA Accounting Guidelines and the consensus views of the CICA Emerging Issues Committee since these sources represent considered views of informed accountants on areas for which there are no specific standards." *Id.*

378. An issuer, even if organized under foreign law is disqualified if (a) voting securities carrying over 50% of the vote for the election of directors are held by persons whose last address as shown on the books of the issuers is in Canada, and (b) *either* (i) the majority of the senior officers or directors of the issuer are citizens or residents of Canada; (ii) more than 50% of the assets of the issuer are located in Canada; *or* (iii) the business of the issuer is administered principally in Canada. Policy Statement, *supra* note 359, at §2(17). The Policy Statement establishes presumptions in this regard in certain cases. *See id.* at §4.2. A bidder using the CMJDS to extend a tender offer to Canadian residents in accordance with U.S. requirements, as permitted by §4 of the Policy Statement, must ensure, *inter alia*, that the target company qualifies as a foreign issuer. *Id.* at §4.2(1), §2(47). As stated, an issuer does not qualify as a foreign issuer where more than 50% of the voting power of the corporation is held by Canadian residents if certain other conditions are met. *Id.* at §2(17)(a). Under §4.2, it is conclusively presumed that such disqualification does not exist in specified cases generally involving non-negotiable or hostile bids, unless the tests set forth in §4.2 are satisfied.

379. *Id.* at §2(18). Canadian underwriters are subject to conflict of interest provisions regulating distributions of "related" or "connected" issuers. *See* OSA Reg. §§194, *et. seq.*, Can. Sec. L. Rep. (CCH) ¶453-229, at 55,366-55,372. *See infra* §1.16[6] regarding the corresponding treatment under CMJDS.

380. Policy Statement, *supra* note 359, at §2(20). As of 1990, the International Accounting Standards Committee (IASC) had adopted 29 IASs. IASC's objectives are (i) to formulate and publish accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance, and (ii) to work generally for the improvement and harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements. IASC Constitution, No. 2, Objectives and Procedures, Appendix 2, §9000.58 (Jan. 1983), American Institute of Certified Public Accountants, Professional Standards (CCH), at 11,035.

date specified in the Policy Statement; or the average of the bid and asked prices of the securities in such market if there were no sales on the specified date.[381]

"Public float" means the aggregate market value of securities held by persons or companies not affiliates of the issuer.[382]

A "securities exchange bid" is a takeover bid or an issuer bid for which the consideration for the securities of the target company consists, in whole or in part, of securities of the offeror or of another issuer.[383] A "takeover bid," insofar as the application of the Policy Statement in a province is concerned, has the same meaning given the term in the securities legislation of the particular province.[384] The Policy Statement provides a corresponding definition for an "issuer bid."[385]

"U.S. issuer" is a foreign issuer (as defined) incorporated or organized under the laws of the United States or any state, territory or the District of Columbia.[386]

Although not a defined term, the concept of a "substantiality" test, based upon market value and public float of the issuer's securities,[387] plays a pivotal role in CMJDS. Any U.S. reporting issuer that has been such for thirty months and meets the substantiality requirement set forth in Section 3.3(2) (market value and public float of U.S. $300 million and $75 million, respectively) may use the CMJDS for the distribution of any security.[388] Although it only an approximation of market efficiency at best, for ease of reference this substantiality test is sometimes referred to hereinafter as the "efficient market substantiality test." There are lesser substantiality requirements associated with specific types of offerings under CMJDS as discussed below.[389]

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381. Policy Statement, *supra* note 359, §2(24). A different rule is provided if there is not market for the class of securities in question. *Id.* In such cases, "market value" means "book value" as determined on the date specified in the applicable provision of the Policy Statement. *Id.* If the issuer is in bankruptcy, receivership, or has an accumulated capital deficit, "market value" means one third of the principal amount, par value or stated value of the class of securities in question. It is not clear why "market value" in this context is based upon par or stated value since par or stated value generally do not bear any relationship to market value.

382. *Id.* at §2(37).

383. *Id.* at §2(44).

384. *Id.* at §2(46).

385. *Id.* at §2(22).

386. *Id.* at §2(47).

387. *Id.* at §3.3.

388. *Id.* at §3.3(2). The valuation must be made as of a date within 60 days prior to the filing of the preliminary prospectus with the principal jurisdiction.

389. Other applications of the substantiality test include market value and public float of U.S. $150 million and U.S. $75 million, respectively, for convertible investment grade securities, *see id.* at §3.2(6)(b), and certain guaranteed issues, *id.* at §3.6 (1)(b); and public float of U.S. $75 million for certain securities exchange bids, *id.* §4.4(4)(a), and business combinations, *id.* §5.2.

[3] *Common Requirements*

The Canadian MJDS is available for several different types of offerings by U.S. issuers including offerings of investment grade securities,[390] exchange bids,[391] business combinations,[392] rights offerings,[393] and, if the issuer meets the efficient market substantiality test, any other offering.[394] Each of these categories requires, at a minimum, that the issuer meet a set of common eligibility requirements set forth in Section 3.2(1)-(5) of the Policy Statement. The issuer must be a "foreign issuer," as defined, incorporated or organized under the laws of the United States or any state, territory thereof, or the District of Columbia.[395] Further, the issuer must be an SEC reporting issuer[396] and have filed all required material for the thirty six calendar months preceding the filing of the preliminary prospectus with the principal jurisdiction,[397] special provision being made for successor issuers.[398] Finally, the issuer must not be registered (or required to be registered) as an investment company under the U.S. Investment Company Act of 1940 and must not be a commodity pool issuer.[399]

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390. *Id.* at §3.2.
391. *Id.* at §4.4.
392. *Id.* at §5.
393. *Id.* at §3.4.
394. *Id.* at §3.3.
395. *Id.* at §3.2(1).
396. *Id.* at §3.2(2). Specifically, the issuer must have a class of securities registered under Section 12(b) or (g) of the Securities Exchange Act of 1934, or be required to file reports pursuant to Section 15(d) of such Act.
397. *Id.* at §3.2(3). Specifically, the issuer must have filed all the material required to be filed pursuant to Section 13, 14 or 15(d) of the Exchange Act for a period of at least 36 months immediately preceding the filing of the preliminary prospectus with the principal jurisdiction. *Id.* Although this condition requires the issuer to have filed all material required to be filed under the specified provisions prior to using MJDS, literally it does not require the information to have been timely filed. *Cf.* SEC Form S-3, General Instruction I.A.3.(b) ("has filed in a timely manner all reports required to be filed"). Section 3.2(3) of the Policy Statement, which contains the reporting requirement, corresponds to the U.S. MJDS which requires a Canadian issuer to have at least a three year history of reporting with a Canadian securities regulatory authority for any type of CMJDS offering. MJDS Release, *supra* note 4, at 81,865. In contrast, Proposed Form F-11-recently proposed U.S. registration form for certain rights offerings by any qualified foreign private issuer (Canadian or non-Canadian)-requires that the issuer either be a reporting issuer in the U.S. or exempt under Rule 12g3-2(b); Form F-11 does not require the issuer to have been subject to the reporting requirements for any particular length of time. Proposed Form F-11, General Instruction I.B. *Accord,* Proposed Form F-12, another recently proposed U.S. registration form for certain exchange offers and business combinations by any foreign private issuer. Form F-12, General Instruction 1. B., 1.C., Instruction 2. *See* §1.05[2].
398. Policy Statement, *supra* note 359, at §3.5.
399. *Id.* at §§3.2(4) and (5). A "commodity pool issuer" is an issuer formed and operated for the purpose of investing in commodity futures contracts, commodity futures and/or related products. *Id.* at §2(10). Under the U.S. MJDS, investment companies registered or required to be registered under the Investment Company Act of 1940 are ineligible for Forms F-7, F-8, F-9 or F-10. In contrast, Forms F-11 and F-12, although generally unavailable for investment companies registered or required to register under the Investment Company Act of 1940, are available to foreign issuers able to make public offerings in the U.S.

In sum, to qualify for the system, the issuer must be a "foreign issuer" organized under U.S. law, an SEC reporting company in compliance with its reporting obligations and not registered or required to register under the Investment Company Act. These requirements, set forth in Section 3.2(1)-(5) of the Policy Statement, are hereafter referred to as the "Common Requirements."

Another requirement, common to some but not all of the categories of transactions encompassed by CMJDS, is that the issuer "has had a class of its securities listed on the New York Stock Exchange or the American Stock Exchange or quoted on NASDAQ NMS for a period of at least twelve calendar months immediately preceding the filing of the preliminary prospectus with the principal jurisdiction and is in compliance with the obligations arising from such listing or quotation."[400] This requirement hereinafter is sometimes referred to as the "Listing Requirement."

[4] *Prospectus Offerings*

The categories of offerings included within CMJDS are (i) non-convertible investment grade debt and preferred shares;[401] (ii) investment grade debt and preferred shares that may not be converted for at least one year after issuance, if the issuer meets a substantiality requirement;[402] (iii) other securities, if the issuer satisfies a greater substantiality requirement;[403] (iv) certain rights offerings,[404] and business combinations and securities exchange bids.[405] Compliance with the Common Requirements is necessary for each category. Both the issuer and selling security holders may sell securities pursuant to the system.[406] CMJDS is available for offerings certain derivative securities, namely, warrants, options, rights and convertible securities if the issuer of the underlying securities is eligible under the Policy Statement.[407] The system is unavailable for offerings of other derivative securities such as stock index warrants, currency warrants and debt the interest of which is keyed to a stock index.[408]

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pursuant to Rule 6c-9 or individual exemptive orders under the Investment Company Act.

400. *See, e.g.*, Policy Statement, *supra* note 359, at §3.4(2)(b). Special provision is made for successor issuers. *See id.* The U.S. MJDS also has a listing requirement applicable to some but not all types of transactions. When applicable, such requirement is satisfied if the issuer has had a class of securities listed on the Montreal Exchange, the Toronto Exchange or the Senior Board of the Vancouver Stock Exchange for the 12 calendar months prior to filing the registration statement. *See, e.g.*, Form F-7, General Instruction I.B.(3); Form F-8, General Instruction II.A.(3), III.A.(2).

401. Policy Statement, *supra* note 359, at §3.2(1) - (5).

402. *Id.* at §3.2(6).

403. *Id.* at §3.3.

404. *Id.* at §3.4.

405. *Id.* at §4.

406. *Id.* at §3.1.

407. *Id.*

408. *Id.*

A seller may distribute investment grade debt and investment grade preferred shares in Canada, or rights immediately exercisable therefor, pursuant to CMJDS provided the issuer and the securities satisfy the Common Requirements. This category includes securities having no less than the fourth highest rating by specified Canadian rating agencies.[409] Investment grade securities that are convertible are eligible for the system only if they are not convertible for at least one year and the issuer's equity shares have a market value and public float of not less than U.S. $150 million and $75 million, respectively.[410] Offerings of other securities, including, without limitation, common shares, also may be offered pursuant to the system, provided the issuer meets the Common Requirements and the issuer's equity shares have a market value and public float of not less than U.S. $300 million and U.S. $75 million, respectively.[411] Thus, large, reporting U.S. issuers are eligible to offer any securities (irrespective of investment quality) pursuant to CMJDS.[412]

A U.S. issuer may use CMJDS for rights offerings if it meets the Common Requirements and the Listing Requirement.[413] As stated, the Listing Requirement provides that the issuer must have had a class of securities listed on the New York Stock Exchange or the American Stock Exchange or quoted on NASDAQ NMS for at least twelve months preceding the filing of the preliminary prospectus with the principal jurisdiction.[414] The rights must be exercisable immediately upon issuance.[415]

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409. *Id.* at §§3.2, 2(4).

410. *Id.* at §3.2(6)(b). The valuation is to be made within 60 days prior to filing the preliminary prospectus with the principal jurisdiction.

411. *Id.* at §3.3(2). The valuation is to be determined as of a date within 60 days prior to filing the preliminary prospectus with the principal jurisdiction.

412. One of the premises of the Canadian MJDS appears to be the so-called "efficient market hypothesis." As stated, under the CMJDS, any securities of a U.S. issuer may be distributed under the system if the issuer meets a "substantiality" test based upon market value and public float of its securities. Policy Statement, *supra* note 359, at §3.3(2). According to the Canadian Securities Administrators, the purpose of this "substantiality" requirement is "to single out issuers whose size is such that (i) information about them is publicly disseminated and (ii) they have a significant market following." Policy Statement, *supra* note 359, at §3.1. "As a result," CSA continued, "the marketplace can be expected to set efficiently a price for the securities of these issuers based upon publicly available information." *Id.* This proposition bears a strong resemblance to the efficient market theory, regarding which, *see generally West, Efficiency of the Securities Markets, in* F. FABOZZI AND ZARB, HANDBOOK OF FINANCIAL MARKETS: SECURITIES, OPTIONS AND FUTURES 23-25 (1981); THE FINANCIAL ANALYST'S HANDBOOK 1227-1228 (Levine, S., ed., 2d. ed. 1988).

413. Policy Statement, *supra* note 359, at §3.4(2). The CMJDS provides that registration as a dealer is not required by an issuer with respect to a rights offering made under the CMJDS. A standby underwriter or dealer manager of a rights offering does not have to register as a dealer in Canada if it does not undertake soliciting activity in Canada or resell in Canada any securities acquired in the standby underwriting. *Id.* at §3.4(4).

414. *Id.* at §3.4(2)(b). The issuer must also be in compliance with its listing or quotation obligations.

415. *Id.* at §3.4(3)(a). The corresponding requirement in the U.S. MJDS, Form F-7, was dropped without explanation upon adoption of the system by the SEC. MJDS Release, *supra* note 4, at 81,871. The CMJDS proposal also indicated that rights must have an exer-

Rights issued to a resident of Canada may not be transferable to another resident of Canada with certain exceptions.[416] Subject to the foregoing, rights issued to residents of Canada must have the same terms and conditions as rights issued to residents of the United States.[417] The CMJDS proposal stated that CMJDS is "not intended to be used to effect an indirect financing in Canada."[418] Accordingly, CMJDS as proposed limited the increase in the number of outstanding securities of the class to be issued to no more than twenty five percent, assuming all rights issued as part of the same offering (or within the previous year as part of another offering) were exercised;[419] otherwise, the rights offering provision of CMJDS would not have been available. The CMJDS as adopted deleted this condition without explanation.[420] Before embarking on an CMJDS-registered rights offering, a U.S. issuer should consider the possibility of conducting the rights offering on an exempt basis in Canada. Prospectus exemptions include, among others (1) sales to a bank, trust company, insurance company and certain other institutions, purchasing as principal;[421] (2) private placements;[422] (3) rights offerings, as well as securities issued upon the exercise of rights;[423] (4) sales of certain securities issued

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cise period not exceeding 90 days. Draft National Policy Statement No. 45, at §3.4(3). This requirement was dropped upon adoption of CMJDS, and the corresponding provision in the U.S. MJDS was dropped without explanation upon adoption by the SEC. *See* MJDS Release, *supra* note 4, at 81,871.

416. Policy Statement, *supra* note 359, at §3.4(3)(c). Rights may be transferred to other Canadian residents who were granted rights of the same issue by the issuer. *Id.* In addition, the prohibition on transfer of rights does not affect transfer of securities issuable upon exercise of the rights, nor does it affect the transfer of rights on a securities exchange or inter-dealer quotation system outside of Canada. *Id.* The general restriction on transferability of rights appears to be based upon the proposition that CMJDS should not allow U.S. issuers to extend rights offerings to new investors in Canada. *Cf.* MJDS Release, *supra* note 4, at 81,872. Apparently, CSA intended such offerings to be made under CMJDS only if they independently qualify under another provision.

417. Policy Statement, *supra* note 359, at §3.4(3)(b).

418. *Id.* at §3.4(1).

419. Draft Policy Statement, *supra* note 362, at §3.4(3)(d). The same limitation would have applied, in the case of debt, to the increase in the aggregate principal amount of long-term debt to be outstanding after the rights offering. *Id.*

420. The SEC also deleted the 25% condition upon adoption of the U.S. MJDS. The SEC explained that, "[u]pon reconsideration, the limitation was judged unnecessary for, and in some cases inconsistent with, U.S. investors' interests." MJDS Release, *supra* note 4, at 81,871-81,872. Form F-11, which the Commission proposed in June 1991, also does not have a 25% limitation. Form F-11 is a registration form available for the registration in the U.S. of equity securities offered upon the exercise of rights granted by foreign private issuers. *See supra* §1.04[2].

421. ICMSR, *supra*, note 289, at §4.05[1]; OSA §71(1)(a)(c).

422. ICMSR §4.05[1]; OSA §71(d) (purchase as principal of specified amount). The seller must file a report with the OSC within ten days. OSA §71(1)(3). Private placements to institutions are common methods of financing in Canada. *See* ICMSR §4.01[5].

423. OSA §71(h). Subject to regulations of the OSC, the prospectus requirements of the Ontario Securities Act do not apply where, inter alia, "the trade is made by an issuer in a right, transferable or otherwise granted by the issuer to holders of its securities to purchase additional securities of its own issue and the issue of securities pursuant to the

in connection with a statutory amalgamation or arrangement;[424] (5) sales by an issuer of its own securities to employees;[425] (6) certain "limited offerings;"[426] and (7) placements of "Eligible Eurosecurities."[427] In Ontario, the exemption for rights offerings is not available, however, if the offering would result in an increase of more than twenty five percent in the number of securities of the subject class, or if the offering "is for the purpose

exercise of the right." OSA §71(1)(h). This exemption requires the issuer to notify the Commission of the proposed offering, and is not available if the Commission objects within ten days of notice. *See generally* ICMSR §4.05[1]. *See also* Uniform Act Policy 2-05, [3] Can. Sec. L. Rep. (CCH) ¶470-205; Ontario Policy 6.2, [3] Can. Sec. L. Rep. (CCH) 471-602. Ontario Policy 6.2 sets forth certain grounds upon which the OSC will object to rights offerings proposed to be made under the exemption provided by §71(1)(h) of the Act. "The Commission has concluded that, generally speaking, a major financing by way of rights offering should be made pursuant to a prospectus. . . ." The Director accordingly will object to rights offerings proposed to be made under §71(1)(h) where the proposed offering, if completely subscribed, would result in an increase of more than 25% in the number of the securities of the class to be issued upon the exercise of rights (or in the case of debt, 25% of principal amount). Ontario Policy 6.2, III.3.(a). The Director will also object "where the offering is for the purpose of financing a major new undertaking." *Id.* at III.3.(c). The Policy Statement as initially proposed contained a provision corresponding to this 25% limitation. Draft Policy Statement No. 45, *supra* note 362, at 3.4(3)(d). Under Draft Policy Statement No. 45, CMJDS would have been available for rights offerings only if, generally, the number of outstanding securities of the class to be issued would not increase by more than 25%. *Id.* The CSA deleted this provision upon adoption.

424. Policy Statement, *supra* note 359, at §5.1; OSA §71(1)(i); ICMSR §4.05[1]. This exemption covers securities issued as consideration in the typical business combination. MJDS Release, *supra* note 4, at 81,870. The basis for the exemption is that disclosure is made in the information circular required under proxy rules so that prospectus disclosure is unnecessary. *Id.* At least some of the provinces have recently required prospectus-level disclosure in information circulares used in connection with business combinations. *Id.* Since the terms "amalgamation" and "arrangement" are not defined in the securities laws, it is necessary to rely upon companies laws to determine the scope of these exemptions. ICMSR §4.05[1]. Business combinations involving "significant asset transactions" under Canadian law may be subject to additional regulation in Canada. MJDS Release, *supra* note 4, at 81,881. Regarding mergers and other corporate combinations in Canada, see generally ICMSR §4.09.

425. ICMSR, *supra*, note 289, at §4.05[1]; OSA §71(1)(n).

426. ICMSR, *supra*, note 289, at §4.05[1]; OSA §71(1)¶.

427. *In the Matter of Eurosecurity Financing*, OSC Blanket Order (Nov. 22, 1984), Can. Sec. L. Rep. (CCH) ¶473-033, at 58,523. The Ontario Securities Act, §73(1), authorizes the Commission to rule that any transaction, security or person is not subject to, inter alia, the prospectus requirement of §52 of the Act if such ruling is not prejudicial to the public interest. Pursuant to this authority, the Ontario Securities Commission ruled on November 22, 1984, that during a "distribution period," as defined, except for trades otherwise made in conformity to the Act, the prospectus requirement does not apply to a trade of "Eligible Eurosecurities" where the purchaser is an "Eligible Eurosecurity Purchaser," as defined. The "Eligible Eurosecurity Purchaser" may sell Eurosecurities to a non-Canadian resident which is not a "Eligible European Purchaser" under certain circumstances. noteeither of these exemptions is applicable if the trade is a "distribution" within the meaning of the Act. The "Eurosecurity market" is the "international market that exists outside Canada for the initial distribution of securities . . . to persons whose ordinary business it is to buy and sell such securities . . . , and in respect of which an international secondary market may develop where settlement is in a Eurocurrency."

of financing a major new undertaking."[428]

The Policy Statement provides an alternative eligibility requirement for certain guaranteed securities.[429] To qualify for this requirement, the issuer must be a "foreign issuer" organized under U.S. law, and must not be an investment company (registered or required to register under the Investment Company Act) or commodity pool issuer.[430] The parent company of the issuer must guarantee the securities being offered.[431] The Policy Statement establishes with specificity which securities qualify for this alternative treatment.[432]

[5] *Business Combinations and Securities Exchange Bids*

CMJDS is available for the distribution of securities of a U.S. issuer as part of a business combination if less than forty percent of the securities being distributed would be held by Canadian residents.[433] Securities may be distributed pursuant to CMJDS to security holders in Canada "by a successor issuer subsisting after the business combination" if certain conditions are met,[434] with a common exception to such conditions for smaller participants in the transaction.[435] A U.S. issuer may issue securities pursuant to CMJDS in connection with a business combination on the basis of U.S. disclosure requirements, if, with the exception of certain smaller participants referred to immediately above: (i) each participant in the business combination meets the Common Requirements[436] (e.g., each is a U.S. issuer); (ii) the equity shares of each participant in the business combination have a public float of not less than U.S. $75 million;[437] (iii) each participant in the business combination meets the

428. Ontario Securities Commission Policy 6.2, [Vol. 3] Can. Sec. L. Rep. (CCH) ¶471-602, at 58,105.

429. Policy Statement, *supra* note 359, at §3.6.

430. *Id.* at §3.6(2).

431. *Id.* at §3.6(3).

432. The securities being offered must fall into one of three categories: (a) non-convertible in-vestment grade securities of a majority-owned subsidiary whose parent meets the Common Requirements; (b) certain convertible investment grade securities of a majority owned subsidiary; or (c) certain other securities where the parent of the issuer meets a substantiality requirement, among other conditions. *Id.*

433. *Id.* at §5.1.

434. *Id.* at §5.2.

435. Certain of the eligibility requirements for business combinations, specified in §5.2, do not apply in respect of a participant in the transaction whose assets and gross revenues would contribute less than 20% of the total assets and gross revenues from continuing operations before income taxes, extraordinary items and cumulative effects of a change in accounting principles of the successor issuer, as measured based on a pro forma combination of the participating persons' and companies' most recently completed fiscal years. *Id.* at §5.2 (1).

436. The exception for smaller participants in the transaction does not apply to all of the Common Requirements, but rather, only those set forth in §3.2(2)-(3). Thus, the minor transaction participants are not required to be reporting companies.

437. Policy Statement, *supra*, note 359, at §5.2(2). The valuation is to be made as of a date within 60 days prior to the filing of the preliminary prospectus with the principal

Listing Requirement.[438] In addition, CMJDS is available in this context only if the terms of the transaction apply equally to Canadian and U.S. residents, and less than 40% of the class of securities to be distributed would be distributed to Canadian residents.[439] There is no exception from these latter two requirements.

A "securities exchange bid" is a takeover or issuer bid in which the consideration offered consists in whole or part of securities of an offeror or other issuer.[440] Section 4.4 of CMJDS allows, under certain circumstances, the bidder to comply with the requirements of U.S. law to satisfy Canadian prospectus requirements applicable to the exchange of securities. A U.S. issuer may rely on this provision if the tender offer itself meets the requirements of CMJDS;[441] the bidder (or the issuer of the securities being offered) meets the Common Requirements;[442] the bidder (or the issuer of the securities being offered), meets the Listing Requirement;[443] and at least one of the following conditions are satisfied: (i) the bidder (or issuer of the securities being offered) meets a specified substantiality requirement;[444] (ii) the securities being offered are non-convertible investment grade debt or preferred shares (i.e., shares having an "Approved Rating"); or (iii) the bid is an "issuer bid" made under CMJDS with securities of the issuer offered as consideration.[445] MJDS also permits eligible takeover bids and issuer bids to be made to Canadian residents on the basis of U.S. tender offer rules.[446] Generally, qualifying tender offers would be exempt from most provisions of provincial law governing the conduct of the bid.[447] The bidder would be required to

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jurisdiction.

438. *Id.* at §5.2. *See also id.* at §3.5. (successor issuers).

439. *Id.* at §§5.2(4) and (5). Technically, the 40% limitation applies to "persons or companies whose last address as shown on the books of the participating person or company is in Canada." *Id.* at §5.2(5). Section 5.2 of the Policy Statement establishes specific rules governing this calculation.

440. *Id.* at §2(44).

441. *Id.* at §4.4(1). Specifically, the offeree issuer (i.e., the target company) and the tender offer itself must meet the requirements of Section 4.2 of the Policy Statement. Section 4.2 sets forth the conditions pursuant to which a bidder may make a tender offer in reliance upon U.S. rather than Canadian tender offer rules. *See infra.* §1.16[7].

442. The relevant date for measuring the three-year reporting period in this context, see Policy Statement, *supra* note 359, at §3.2(3), is the filing of the registration statement with the SEC rather than the filing of the preliminary prospectus with the principal jurisdiction. *Id.* at §4.4(2). The bidder making a securities exchange bid must file the registration statement with each applicable securities regulatory authority in Canada. *Id.* §4.5(5).

443. The securities must have been listed (or quoted on NASDAQ NMS) for at least 12 calendar months immediately preceding filing of the registration statement with the SEC, and the issuer must be in compliance with its obligations arising from such listing (or quotation).

444. Policy Statement, *supra* note 359, at §4.4(4). Specifically, the bidder's equity shares (or those of another issuer if securities of another issuer are being offered) must have a public float of $75 million.

445. *Id.* at §4.4(4).

446. *Id.* at §4.

447. *Id.*

comply with the Williams Act in connection with takeover bids made under MJDS.[448]

[6] *Other Substantive and Disclosure Requirements*

A U.S. issuer registering securities for sale in Canada pursuant to CMJDS and in the United States would prepare the registration statement pursuant to SEC disclosure requirements.[449] Except where expressly required in the Policy Statement, the registration statement or other disclosure documents need not comply with Canadian law. If the issuer intends to sell securities in both the U.S. and Canada, it files a registration statement with both the SEC and the principal jurisdiction.[450] The Policy Statement specifies filing requirements which apply in respect of sales in non-principal jurisdictions.[451] If the issuer intends to sell securities solely in Canada, it prepares the preliminary prospectus, prospectus and each amendment as if it were also offering the securities in the United States.[452] In this case it is not required to prepare the cover page of the registration statement or other information not required in the prospectus.[453]

A U.S. issuer using CMJDS generally complies with the financial statement requirements that would apply if the securities were being registered for sale in the United States.[454] The U.S. issuer is not required to reconcile its financial statements to non-U.S. accounting principles, unless it is offering securities pursuant to Section 3.3 of the Policy Statement (i.e., non-investment grade securities) in which case it is required to provide a reconciliation to Canadian GAAP[455] or to International Accounting Standards[456] of the financial statements included or incorporated by reference in the preliminary prospectus or prospectus.[457] The is-

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448. *Id.*
449. *Id.* at §3.8(1).
450. *Id.* at §3.8.
451. *Id.*
452. *Id.*
453. *Id.* at §3.8(1).
454. *Id.* at §3.10.
455. *See* text at §1.16[6].
456. Draft Policy Statement No. 45 required the conciliation in the case of offerings pursuant to §3.3 to be made to Canadian GAAP. Draft Policy Statement, *supra*, note 359, at §3.10. Without discussion, the Policy Statement as adopted permits the issuer to reconcile to Canadian GAAP or to International Accounting Standards ("IASs"). This is a significant development for IASs which to date have not received wide recognition. The International Accounting Standards Committee ("IASC"), which promulgates IASs, was formed in 1973. As of 1989 IASC had a membership of about one hundred accountancy bodies from about eighty countries. The members of the Committee are accountancy bodies (such as the American Institute of Certified Public Accountants in the United States) rather than countries. noteeither the IASC nor the accountancy profession has the power to require compliance with international accounting standards. Preface to Statements of International Accounting Standards, No. 19, Objectives and Procedures, App. 4, §9000.60 (Jan. 1983), American Institute of Certified Public Accountants, Professional Standards (CCH), at 11,052-11,053.
457. Policy Statement, *supra* note 359, at §3.10.

suer should provide the reconciliation in the notes to the financial statements or as a supplement to be contained within or incorporated by reference in the preliminary prospectus and prospectus.[458] The reconciliation must "explain and *quantify* as a separate reconciling item any significant differences between the principles applied in the financial statements (including note disclosure) and Canadian GAAP or International Accounting Standards. . . ."[459] In the case of annual financial statements, the reconciliation must be covered by an auditor's report.[460]

The reconciliation requirement described above applies in the case of offerings pursuant to Section 3.3 of the Policy Statement.[461] Section 3.3 applies to offerings of securities not eligible for one of the other categories sanctioned by CMJDS (i.e., investment grade securities, rights offerings, securities exchange bids and business combinations). Section 3.3 is only available if the issuer meets the "efficient market substantiality test."[462] The reconciliation requirement significantly diminishes the utility of CMJDS for these offerings of securities, since a reconciliation to Canadian GAAP or IASs may not be significantly less burdensome than complying with the full requirements.[463] Although the issuer will be able to prepare most of the remainder of the disclosure document in accordance with U.S. rather than Canadian requirements, foreign accounting and auditing principles are usually considered to be the most difficult aspect of complying with a foreign disclosure system.

Another provision affecting the content of the prospectus is the language requirement of Section 3.8 applicable to filings made in Quebec.[464] CMJDS requires both English and French language versions of the preliminary prospectus, final prospectus, amendments, supplements and documents incorporated by reference to be filed if offers will be made in Quebec. The French language version of continuous disclosure documents need not be filed unless and until incorporated by reference into the pro-

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458. *Id.*

459. *Id.* (emphasis added).

460. *Id.* The Policy Statement is silent as to whether the audit and auditor must meet provincial auditing and auditor independence standards. *See, e.g.*, National Policy Statement No. 3, Unacceptable Auditors, [Vol. 3] Can. Sec. L. Rep. (CCH) ¶470-003, at 57,561 (auditor's report unacceptable under specified circumstances). The United States, of course, has strict audit requirements including stringent requirements concerning the independence of the auditor. *See* Codification of Financial Reporting Policies, §601.01, §602.02a, [Vol. 6] Fed. Sec. L. Rep. (CCH) ¶73,251 at 62,881, 62,885; Rule 2.01(b) of Reg. S-X, Fed. Sec. L. Rep. (CCH) ¶69,122, at 61,011.

461. Policy Statement, *supra* note 359, at §3.10.

462. *See supra* §1.16[3] (market value and public float of U.S. $300 million and $75 million, respectively).

463. "The reconciliation shall explain and quantify as a separate reconciling item any significant differences between the principles applied in the financial statements (including note disclosure) and Canadian GAAP or International Accounting Standards, as the case may be, and, in the case of the annual financial statements, shall be covered by an auditor's report." Policy Statement, *supra* note 359, at §3.10 (emphasis added).

464. Policy Statement, *supra* note 359, at §3.8.

spectus.[465] Information contained in a Form 10-K or 10-Q that is not required to be disclosed under Quebec requirements applicable to the offering need not be included in the French language version of such documents.[466] The French language requirement of the CMJDS will constitute an impediment to cross-border capital flows between the United States and Quebec and it remains to be seen whether the imposition of this requirement was a wise policy choice for Quebec which presumably instigated it. The CMJDS as adopted, in a change from the proposed version, does provide that a seller does not have to file French language versions of disclosure documents for certain rights offerings and tender offers made under the Policy Statement.[467]

Each preliminary and final prospectus used in Canada under CMJDS must include a certificate from the issuer to the effect that the prospectus (together with the documents incorporated by reference), "constitutes full, true and plain disclosure of all material facts relating to the securities offered by this prospectus. . . ."[468] The underwriter must give the identical certificate to the best of its "knowledge, information and belief."[469] The Policy Statement establishes special certificate requirements for Rule 415 and 430A offerings.[470] In addition to satisfying the certification requirement discussed above, underwriters of offerings in Canada pursuant to CMJDS must observe the conflict of interest requirements of provincial law.[471] These provisions regulate conflicts of interest arising in connection with the sale of securities of related parties of the underwriter. CMJDS specifies the extent to which the participation of an independent underwriter is required under the system when otherwise required by Canadian law.[472]

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465. *Id.*

466. *Id.* at §3.8(1).

467. *Id.* at §3.8(1). The seller is not required to file French language versions of the disclosure documents for rights offerings under §3.4, unless the issuer is a reporting issuer in Quebec (except if such reporting obligation arose solely as a result of rights offerings made under §3.4) or 20% or more of the class of securities underlying the rights is held by Canadian residents. *Id. Cf. id.* §4.5(1) (seller need not file French language versions of tender offer disclosure materials unless target is reporting in Quebec or 20% test is met).

468. Policy Statement, *supra* note 359, at §3.11 (1). A slightly different certificate is required if the offering is being made in Quebec. *Id.*

469. *Id.*

470. *Id.* at §3.11(2) & (3).

471. OSA Reg. §§ 194, *et seq.* Can. Sec. L. Rep. (CCH) ¶453-299, at 55,366-55,372. These regulations impose limitations on underwriters in the case of distributions of securities of a "related issuer" or "connected issuer" as defined.

472. Policy Statement, *supra* note 359, at §3.12. For offerings made under MJDS in Canada and the U.S., provisions of provincial law requiring the underwriting of part of the distribution by an independent underwriter shall be deemed to have been satisfied if the test set forth in §3.12(2)(a) is satisfied. This test involves the proportion of the offering that is underwritten by independent underwriters compared to the proportion underwritten by dealers related to the issuer. *Id.* For Canada-only offerings, see *id.* §3.12(2)((b). Draft Policy Statement No. 45 would have allowed underwriters to use an alternative test based upon NASD rules. Draft National Policy Statement, *supra* note 362, at §3.12(2)(a)(ii). CSA de-

Although generally is not necessary under CMJDS for the disclosure to conform to the content and form requirements of provincial law,[473] CMJDS does require certain additional legends to be included in preliminary and final prospectuses used in Canada pursuant to the system.[474] These legends relate to, among other things, a warning that the disclosure presented differs from that required under provincial law; difficulties in international service of process and enforcement of judgments; and the withdrawal and other rights provided by Canadian law.[475] Upon filing a final prospectus under CMJDS, an issuer is required to file a "Submission to Jurisdiction and Appointment of Agent for Services of Process."[476] This form requires the issuer irrevocably to submit to the jurisdiction of the courts and administrative tribunals of each of the provinces of Canada in which the securities were being distributed, any administrative proceeding in any such province, and any proceeding relating to the distribution of securities made pursuant to the CMJDS prospectus.[477] Issuers and other selling securities in Canada under CMJDS are also required to comply with provincial rules governing advertising and distribution of material to investors and the press.[478]

The CMJDS sets forth various procedural rules governing filing and review of the prospectus and conduct of the distribution of securities in Canada. In keeping with current practice, at the time of filing the preliminary prospectus in Canada the seller must select from among the provinces a "principal jurisdiction" to review the offering.[479] The jurisdiction selected by the issuer to serve as principal jurisdiction, however, may decline to serve as such.[480] If the seller is offering the securities in both the U.S. and Canada, it must file the registration statement with the principal jurisdiction as nearly as practicable contemporaneously with the filing of the registration statement with the SEC.[481] The seller should also file the preliminary and final prospectuses with the other "applicable securities regulatory authorities,"[482] i.e., the securities authorities in each Canadian province and territory in which securities are offered pursuant to CMJDS. Precise filing requirements are set forth in Section 3.8 of the Policy Statement.

In the case of concurrent offerings in Canada and the U.S., the dis-

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leted the alternative test upon adoption of CMJDS.

473. Policy Statement, *supra* note 359, at §3.8(1).

474. *Id.* at §3.9.

475. *Id.*

476. *Id.* at §3.14(4).

477. *Id.* at Appendix B.

478. *Id.* at §3.8.

479. *Id.* at §3.8(2).

480. *Id.* As of the date of adoption of the Policy Statement, New Brunswick, Prince Edward Island, Newfoundland, Yukon Territory and the Northwest Territories have stated they will not act as principal jurisdiction in MJDS offerings. *Id.* at §3.8(2).

481. *Id.* at §3.8(1).

482. *Id.*

closure documents are subject to SEC review, although Canadian regulatory authorities also will monitor the materials "in order to check compliance with the specific disclosure and filing requirements of [the] Policy Statement."[483] In the "unusual case" where the provincial authorities suspect a "problem with the transaction or the related disclosure" or in "special circumstances," the authorities will review the substance of the disclosure documents.[484] The implication is that in the ordinary case the Canadian regulatory authorities will not subject offering materials filed pursuant to CMJDS to substantive or merit review.[485] This result is consistent with the U.S. MJDS[486] but may work uneasily with some provincial statutes that would appear to prohibit the issuance of a final receipt under specified conditions.

As explained above, an offering may commence in Canada upon the issuance of a "receipt" for the final prospectus. In the typical case of concurrent offerings in the United States and Canada, each provincial regulatory authority will issue a receipt for the final prospectus-in effect permitting securities to be sold in the province-when the registration statement becomes effective with the SEC provided the principal jurisdiction has issued its receipt.[487] The principal jurisdiction will issue its receipt for a prospectus after the SEC has declared the related registration statement effective, unless it suspects a problem with the transaction or disclosure or special circumstances exist.[488] The securities regulatory authorities of other provinces also will not issue receipts if they suspect problems with the transaction or disclosure or special circumstances exist.[489] A registrant may also apply for a single "National Policy Statement No. 1 Receipt" that would permit securities to be distributed in all provinces in which the issuer has filed a preliminary prospectus (assuming the province has not opted out of the National Policy Statement No. 1 Receipt System).[490]

[7] *Tender Offers*

The CMJDS permits qualifying tender offers for U.S. target companies to be extended to Canadian residents on the basis of U.S. rather than

483. *Id.* at §3.8(3).

484. *Id.*

485. *See id.*

486. The MJDS Release provides: "Review of the disclosure document will be undertaken by Canadian securities authorities and generally will be that customary in Canada. Thus, except in the unusual case where the Commission's staff has reason to believe there is a problem with the filing or the offering, the documents will be given a 'no review' status by the Commission. For the most part, since the MJDS Securities Act forms become effective upon filing, any Commission review would be undertaken after effectiveness." MJDS Release, *supra* note 4, at 81,877.

487. Policy Statement, *supra* note 359, at §3.8(4).

488. *Id.*

489. *Id.*

490. *Id.*

Canadian law. To qualify, the target company must be a U.S. issuer,[491] and Canadian residents must hold less than forty percent of the securities that are the subject of the offer.[492] The bid must be extended to all holders of the class of securities in Canada and the United States and must be made on the same terms and conditions to all security holders. Compliance with the requirements of the CMJDS exempts the bidder from the tender offer provisions of the Canadian securities laws except those relating to the filing with appropriate regulatory authorities and delivery to security holders of a bid circular and a director's recommendation. Such documents, however, may com-ply with the form and content requirements of U.S. rather than Canadian law provided they contain no false or misleading statement. The bidder must comply with the applicable provisions of Sections 14(d) and (e) (or Section 13(e) in the case of an issuer bid) of the Exchange Act and the regulations adopted thereunder and the officers and directors of the target must comply with the provisions under the Williams Act relating to recommendations by the board and company.[493]

[8] *Liability and Continuous Disclosure*

CMJDS does not affect any of the liability provisions of the provincial securities laws.[494] Thus, the issuer, directors, underwriters, consenting experts and possibly others could be subject to civil, criminal and administrative liability for any misrepresentations in the prospectus, as determined under Canadian law by Canadian courts.[495] CMJDS does not affect the authority of a Canadian regulatory authority to stop a distribution, prevent reliance on an exemption, halt trading or refuse to issue prospectus receipts.[496] The Canadian regulatory agencies will "continue to exercise their public interest jurisdiction in specific cases where they determine that it is necessary to do so in order to preserve the integrity of the Canadian capital markets."[497] Although a user of CMJDS who violates a U.S. securities law requirement incorporated, in effect, into CMJDS may be deemed to have violated a corresponding Canadian requirement, the

491. "U.S. issuer" is a foreign issuer (as defined) incorporated or organized under the laws of the United States or any state, territory or the District of Columbia. An issuer, even if organized under foreign law is not a foreign issuer if (a) voting securities carrying over 50% of the vote for the election of directors are held by persons whose last address as shown on the books of the issuers is in Canada, and (b) either (i) the majority of the senior officers or directors of the issuer are citizens or residents of Canada; (ii) more than 50% of the assets of the issuer are located in Canada; or (iii) the business of the issuer is administered principally in Canada. Policy Statement, *supra* note 359, at §2(17). The Policy Statement establishes presumptions in this regard in certain cases. *See* Policy Statement, *supra* note 359, at §4.2.

492. Policy Statement, *supra* note 359, at §4.1.

493. *Id.* at §4.3.

494. *Id.* at §1.

495. *See* ICMSR, *supra* note 289, at §4.12; OSA, §126(1).

496. Policy Statement, *supra* note 359, at §1.

497. *Id.*

CMJDS user will not be disqualified from using the system with respect to a transaction or document.[498]

A U.S. issuer making a public offering in Canada ordinarily would be subject to Canadian continuous reporting, insider reporting and proxy requirements.[499] For example, an issuer that files a prospectus with the Ontario Securities Commission becomes a "reporting issuer" and, as such, must comply with the periodic reporting requirements.[500] Compliance by a U.S. reporting issuer with U.S. requirements relating to current reports, annual reports and proxy statements, however, will constitute compliance with Canadian laws relating to reports of material change, annual reports, and information and proxy circulares, if the issuer complies with the filing and dissemination requirements of Sec. 6 of the Policy Statement. Compliance by non-reporting issuers with U.S. proxy requirements in respect of a U.S. reporting issuer will satisfy Canadian requirements provided such person also complies with the filing and dissemination requirements of Section 6. The Policy Statement also provides for satisfaction of Canadian requirements relating to interim and annual financial statements, and press releases, if certain conditions are met.[501] If the issuer complies with the requirements of Rule 14a-3 under the Exchange Act relating to shareholder communications, it is not required to comply with National Policy Statement No. 41, but any Canadian Clearing agency and any Canadian intermediary holding of record shares of the issuer is required to comply with National Policy Statement No. 41 within the time limitations established by that Policy Statement for forward proxy-related materials and the like and is entitled to receive the fees and charges provided for in that Policy Statement.[502] The CMJDS also provides that any insider of a U.S. issuer required to file insider reports with respect to holdings of securities of the issuer with any Canadian securities regulatory authority shall not be required to file such reports so long as insider files the reports required under the Exchange Act with the SEC on a timely basis.

§1.17 Critique

The U.S. Multijurisdictional Disclosure System presently is limited to Canadian issuers and to issuers and offerings meeting substantiality, reporting, and/or other criteria. The extent to which it will encourage cross-border offerings between Canada and the United States cannot be immediately measured, although the convenience and increased efficiency for eligible issuers is apparent.

The Canadian multijurisdictional disclosure system will simplify the

498. *Id.*
499. *Id.* at §6.
500. OSA, §1(1)(38).
501. Policy Statement, *supra* note 359, at §6.
502. *Id.*

process of financing in Canada by allowing U.S. issuers generally to follow home country requirements. However, the new system is not expected to open the floodgates to public offerings in Canada by U.S. companies. Although Ontario already makes accommodations for offerings by foreign issuers, and allows the use of home country reports to satisfy continuous reporting obligations, financing there by U.S. issuers has been modest to date. Nevertheless, CMJDS will undoubtedly facilitate multinational offerings, including the addition of a Canadian tranche in connection with otherwise routine domestic financing.

MJDS' and CMJDS' significance does not depend solely upon a statistical measure of resulting capital flows. The process demonstrates that disclosure schemes outside of the United States may have enough similarities to that of the U.S. that each country can accept the others, notwithstanding significant differences of detail. The ability to find common denominators not only reflects the increased sophistication of disclosure schemes outside the United States, but the technical competence of the staffs of the SEC and, in this instance, its Canadian counterparts, in sorting out the technical details and reaching agreement on reciprocal requirements and mechanics.

In connection with rights offerings, the issuer if relying amended Form F-3 would have to be a U.S. reporting company; if relying on Form F-11 or the Rule 801 exemption it would have to be a U.S. reporting company or have made filings pursuant to the Section 12g3-2(b) exemption, whereas a Canadian foreign issuer relying on Form F-7 would not have to be a reporting U.S. issuer. The F-7 registrant has to have it securities listed on one of the designated securities Canadian stock exchanges and have been subject to reporting requirements under applicable Canadian securities laws for three years. The F-11 registrant if not a reporting company but relying on the 12g3-2(b) exemption would also have to have a class of securities listed or quoted on a designated overseas securities market. Either such listing must have been in effect for the preceding thirty six consecutive months or the registrant must have a float of $75 million. The latter requirement is to assure that the registrant is not a start-up and, if a company that has gone public recently, that it has a significant float. The issuer, however, could be a start-up without a significant float if it were prepared to register a class of its securities under the Exchange Act and, thus, become a reporting company. The requirement that the issuer either be a reporting company or have made filings pursuant to the Section 12g3-2(b) exemption is to assure that there is public information relating to the company. But if it is required to be listed or quoted on a DOSM, the information that it includes in its prospectus presumably will be based on the requirements of the DOSM and, hence, is likely to be substantially the same information that it is required to file under Section 12g3-2(b) and will, unlike the 12g3-2(b) filings, will have to be translated into English if in a foreign language. Further, the issuer will be exempt from the Section 15(d) reporting requirements; hence, if it relied on its Section 12g3-2(b) exemption the only filings it will make are those required by that exemption, which filings do not have to be translated.

The foreign issuer, assuming Form F-3 is amended as proposed, must be a reporting company and must have filed one annual report (presumably, in most instances, on Form 20-F). The prospectus will be the abbreviated Form F-3 prospectus incorporating by reference the last annual report and including information relating to distribution terms, use of offering proceeds and other offering specific information. Since a foreign issuer eligible to use Form F-3, if amended, will also be eligible to use Form F-11, the principal reason to elect to use Form F-3 would be the perception that it would afford better protection against Section 11 liability. Form F-3 also has the advantage that the rights will be freely transferable whereas under any of the other alternatives discussed they can be transferred only pursuant to Regulation S.

A Canadian foreign issuer eligible to use Form F-7 could use Form F-11 by becoming a U.S. reporting company (which presumably it wouldn't do, unless it already was one) or by filing for the Section 12g3-b(2) exemption. If it met the one year F-7 listing requirement, but had been listed for less than one year than it would also have to satisfy the $75 million float requirement in order to use F-11. There appears no advantage, however, to using Form F-11 rather than Form F-7. Accordingly, the Canadian issuers that use Form F-11 are likely to be those that cannot meet the Form F-7 eligibility requirements. Form F-11 to this extent adds another alternative for Canadian issuers with no corresponding alternative to U.S. issuers making a rights offering in Canada.

BOOK NOTES

HENKIN, LOUIS, ET. AL., MIGHT V. RIGHT; Council on Foreign Relations Books, New York, NY (1991); $14.95; ISBN 0-87609-109-5; 200pp.

This second edition includes, as did the first edition, a series of essays by acclaimed authors in the field of international law. The essays ask the question: Does international law permit the use of military force to promote democracy and human rights? Also included in the second edition is an extensive revised list of suggested readings.

The series of essays effectively communicates the tension between force and law in U. S. foreign policy. Each author conveys a different viewpoint on the basic theme: man's readiness to settle differences by force in contrast to man's attempts to limit such use of force. The introduction questions whether it is still a feasible or even worthy goal to replace force with reason. Another critical debate explored by the essays is that of the interaction of law and policy. Most significantly, the tumultuous future for democracy and of human rights, in light of the massive political changes in the former Soviet Union, Eastern Europe, and elsewhere in the world is dramatically suggested by the series.

In a chapter new to the second edition, Daniel J. Scheffer examines the controversy surrounding the U.S. invasion of Panama and the U.S.-led response to the Iraqi invasion of Kuwait. He then addresses the post-Cold War role of the U.S. in the "new world order." Scheffer looks at the implications this role has for the use of force in international law.

A new afterward by John Temple Swing, executive vice-president of the Council on Foreign relations, considers the salient elements of the most recent shift in world politics. Swing suggests that a Gorbachev-inspired "new thinking" facilitated movement from U.S. unilateralism toward the collective security envisioned by the United Nations Charter. Swing's essay explores the current dialogue in the U.S. regarding the use of collective force. He concludes with a warning of the potential pitfalls that lie ahead in the effort to develop the "new world order."

The authors include Louis Henkin, Stanley Hoffman, Jeane

Kirkpatrick with Allen Gerson, William D. Rogers, and Daniel Scheffer.

Courtenay Manes

INTERNATIONAL RESPONSES TO TERRORISM: NEW INITIATIVES; Edited by Richard H. Ward and Ahmed Galal Ezeldin; Office of International Criminal Justice, University of Illinois, Chicago (1990); ISBN 0-942511-26-3; 152pp. (hardcover).

This book contains eighteen speeches on international terrorism given at a week-long conference on the subject held in January, 1988 in Cairo, Egypt. The national Police Academy of Egypt and the Office of International Criminal Justice at the University of Illinois co-sponsored the conference. Harold E. Smith, Associate Director of the Office of International Criminal Justice, explains in the book's Foreword that the conference "was designed to serve as a forum for the exploration of terrorism as a worldwide phenomenon."

The topics of the various speeches are as diverse as the authors themselves, from "Political Violence in Northern Ireland" to "INTERPOL's Perspective on International Terrorism." In the opening chapter, David E. Long explores terrorism from the United States perspective. He briefly explains the beginnings of the U.S. anti-terrorism policy of the 1980s, identifying its basic elements. For a slightly different perspective, the Honorable Chancellor Samir Nagy presents the legal aspects of combatting international terrorism. Specifically, he outlines several binding legal documents created by the United Nations and non-governmental organizations.

The book's strongest advantages are its diverse selection of speakers and topics and its straightforward approach. Responses to international terrorism are often viewed from a solely Western perspective; here, several authors speak with a distinctly Middle Eastern voice. These authors are better able than their Western colleagues to report on events and steps being taken in their own countries to halt terrorist activities. All the views are presented in an easily understandable manner. Each speech spans only a few pages, offering a basic overview of the subject. Chapter endnotes supply the interested reader with opportunities for further research.

Although the speech topics selected for publication are interesting, information about the speakers themselves is insufficient. A few authors introduce themselves, but a greater number are unrecognizable to one unfamiliar with scholarship on international terrorism. The information presented suggests they are figures of great authority and prestige in their home countries, but this is not confirmed anywhere in the book. Also, because the book simply excerpts from the speeches, topics are dealt with in a cursory fashion. Anyone looking for an in-depth analysis of world reactions to international terrorism would be well-advised to search elsewhere.

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At first glance, this paperback book looks like nothing more than a tremendous directory of Spanish law firms. But this volume provides information for everyone from job seekers to prospective clients to established businesses looking for information on law firms in Spain.

The book is broken down into several sections: Law Firms, Legal and Business Institutions, and Legal and Business Topics. By far the most important section is Law Firms. This section contains much more than basic directory information; it also contains thoughtful information about each firm, such as: what languages are spoken by the firm, what percentage of clients are foreign, and interviews with partners, or top officers in the case of institutions. Because the information was provided directly by the firms, there is more detail for some than for others. Some firms were more eloquent than others in expressing their views on given topics. The type of information provided in these interviews cannot be found anywhere else. The collection of personal views provides invaluable information for job-seekers or the cautious American export company seeking counsel.

The section on Legal and Business Institutions also focuses on the personal interview. An assortment of institutions provide detailed information about the nature of their businesses and their structure.

The final section, Legal and Business Topics, provides the reader with a comprehensive description of specific subjects, also collected through interviews. Here the questions are grouped alphabetically by topic, with several law firms responding. Again, the information is candid.

Explore Publications has taken a novel approach to providing readers with a much needed resource. The attempt to provide the reader with a comprehensive look at the Spanish legal community from a practitioner's view is successful. Well-thought out questions provide the opportunity for Spanish practitioners to express their understanding of the unique manner in which their legal community functions.

Francis Brown

ADAMS, PATRICIA, ODIOUS DEBTS: LOOSE LENDING, CORRUPTION, AND THE THIRD WORLD'S ENVIRONMENTAL LEGACY; Probe International, Earthscan Publications, Ltd. (1991); $19.95; ISBN 0-919849-16-4; 252pp.

"Human beings do not willingly degrade their environment." Patricia Adams introduces her book with a narrative of the ancient *muang faai*,

the thousand-year old system of water management of Northern Thailand. Ancient farmers understood that mutual reliance was necessary for survival and managed to use the rivers to irrigate crops, water animals, and provide for their own needs, and yet still keep the water clean. Adams explains both how the farmers were brought into the system through "sweat equity" — by putting in twice the labor to compensate for the past efforts of others — and how the use of water was prioritized so that in dry years subsistence crops, such as rice, had precedence over cash crops, and distant or difficult to irrigate plots received water first. The system operated on the basis of co-dependence. All of this came to an abrupt halt when the World Bank and other international institutions brought "development" to the remote corners of the globe in the name of "progress."

This book is written in a style easily accessible to the lay-reader. The absence of footnotes makes for comfortable reading. The endnotes provide the academic support for this account of the Third World's environmental destruction and accompanying indebtedness — the double punch of Western "progress." The book's intended audience is varied, and can include environmental activists and pacifists, economists and lawyers, as well as students of world politics.

Patricia Adams portrays the environment's demise in the face of the West's appetite for raw materials: the harvesting of those materials without thought to the downstream effect of logging, deforestation, and damming of rivers. As an example, Adams describes the failure of the Bailvina and Tucurui dams in the Amazon region. According to Adams, this was partially due to inadequate planning for the effect of rising water on the vegetation. The failure to clear the reservoir area of vegetation caused the river to become incapable of supporting previous life forms. Ultimately, the dams were responsible for the demise of over three thousand native Waimiri-Atroari Indians. Adams also describes the effect of "progress" on less publicized ecosystems. The Singrauli agricultural community in India was contaminated by open pit coal mining and coal-fired electric generating plants. In Ethiopia, the Awash River Valley floodplains were destroyed to make way for sugarcane, cotton, and banana plantations. In Botswana, cattle ranching projects destroyed the grasslands and decimated the pastoral peoples' traditional economies.

In the sections on native governments' lack of foresight and greed, Adams documents the enrichment of the government, the capital flight, the revolving door of aid money — which in some cases never reached the Third World country where it was intended to be used — and the concept of "odious debt."

Adams cites Alexander Nahum Sack for the doctrine of odious debt:

> If a despotic power incurs a debt not for the needs or in the interest of the State but to strengthen its despotic regime, to repress the population that fights against it, etc., this debt is *odious for the population of all the State.*

> This debt is not an obligation for the nation; it is a regime's debt, a personal debt of the power that has incurred it, consequently it falls with the fall of this power.[1]

Adams then chronicals the Third World governments' defrauding of their countries and appropriating aid money for their own use. In the process she makes a very compelling argument for forgiveness of the debt.

Ms. Adams' conclusions are:

(1) The World Bank, international foreign aid agencies such as A.I.D. and CIDA, and the export development agencies such as the Export-Import Bank and the Export Development Corporation should be closed down.

(2) Privatization and respect for property rights are necessary to protect the Third World's environment.

(3) Forgiving the Third World's debt on humanitarian grounds will redound to everyone's sorrow.

(4) The Third World's debt crisis benefitted the environment.

Ruben M. Hernandez

LOWRY, HOUSTON PUTNAM, CRITICAL DOCUMENTS SOURCEBOOK ANNOTATED- INTERNATIONAL COMMERCIAL LAW AND ARBITRATION; Little Brown and Company (1991); ISBN 0-316-53404-8; 532pp. Annotations, bibliography.

Houston Putnam Lowry has assembled ten documents in use in international commercial and corporate practice, and seventeen documents in international arbitration and dispute resolution. He provides the nature and purpose of the document, the countries which have become party to it and a comparison to the U.S. equivalent. The annotations provide specific comparisons to applicable U.S. law, e.g. the Uniform Commercial Code, Statute of Frauds, and the Federal Rules of Civil Procedure. Where applicable, he provides a bibliography of any existing analysis of the document.

Rapidly expanding international market participation by American companies makes the book timely. The expansion of the market itself — the opening of the Eastern Bloc markets and expansion of the European Common Market — also mandates a reference such as this.

Both neophyte and experienced international practitioners are the target audience of the book. Lowry's own previous reliance on a "makeshift, dog-eared photocopy" of necessary international materials prompted him to prepare this sourcebook. This is the first single volume reference of this type to be printed. As the U.S. becomes increasingly more involved in international markets, the value of this resource will

1. *See* PATRICIA ADAMS, ODIOUS DEBTS, at 165.

also increase.

Ruben M. Hernandez

COBBAN, HELENA, THE SUPERPOWERS AND THE SYRIAN-ISRAELI CONFLICT; Praeger Publishers, New York, NY (1991); $19.95; ISBN 0-275-93944-8; 208pp. (hardcover).

Cobban succeeds in offering a detached, unemotional analysis of the highly complex and controversial issue of the Syrian-Israeli dispute. Her analysis begins with the central premise that the dispute is a function of local rivalry, rather than the result of inter-power conflict. Encompassing the evolution of the military balance between Israel and Syria from 1978 through 1990, the book focuses on the effects of the close strategic ties that developed between the two and their superpower partners.

This work was intended as a historical case study of developments among Israel, Syria, the Soviet Union and the United States during this limited period. The goal of this approach was to illustrate valuable lessons for application in the 1990s. After the Gulf War, the work has particular historic relevance.

The book begins with an up-to-the-minute preface analyzing the effects of the Persian Gulf War on the balance of the Syrian-Israeli relationship. Miraculously, the Gulf War aligned Syria and Israel on the "same side" of the conflict, and dramatically altered relations between the two. Cobban analyzes the impact the Gulf war had on Syria and Israel, as well as the impact on the relationship between their superpower allies. Ongoing strife in Lebanon is also addressed, since it proved to be a crucial factor in the Syrian-Israeli relationship, and in that of the powers maneuvering for influence in the Middle East.

Cobban continues her analysis by examining the region's relative immunity to various diplomatic efforts, efforts successful in other areas of the world during the 1980s. Special note is made of the fact that the arsenals of Syria and Israel, now the preeminent powers in the Middle East, remain a serious global threat.

A formula for well-considered diplomacy in the 1990s that could lead to a lasting peace concludes the book. Cobban suggests that policymakers considering the challenge of Arab-Israel peacemaking in this decade can gain useful lessons from the Syrian-Israeli conflict of the 1980s. The most important lesson, says Cobban, is that the volatile conflict between Israel and her neighbors must be moved into real negotiations that address the concerns of all those involved.

MENDES, MARIO MARQUES, ANTITRUST IN A WORLD OF INTERRELATED ECONOMIES; Editions de l'Université de Bruxelles, Belgique (1991); ISBN 2-8004-1019-1; 267pp. Foreword by John H. Jackson, bibliography.

Originally written in 1983-84 as a requirement for an LLM degree from the University of Michigan, this work was expanded and extensively

updated for publication by *Editions de l'Université de Bruxelles*. Mendes' purpose is to provide a comparative analysis of the interplay of U.S. and EEC antitrust laws and trade policy. He has done so amply. A year after publication, it remains a timely and significant work for scholars, lawyers, and government officials.

The increasing interdependence of the world economy provides the base upon which Mendes builds. Because of this interdependence, Mendes argues, the tension created by extraterritorial application of domestic antitrust laws and their conflict with international trade policy is exacerbated. Antitrust laws, in spite of their differences, have in common the regulation of private restraints of trade. The government acts to keep the market free of private intervention. Conversely, trade policy, as exemplified, e.g. by anti-dumping restrictions, is inherently protectionist and involves government intervention to promote the domestic economy.

There has been a degree of international harmonization of trade policy, exemplified by regimes such as that established by the General Agreement on Tariffs and Trade (GATT). There is, however, little accord among national antitrust laws. This discord is illustrated by Mendes through a comparison of U.S. and EEC antitrust laws. Although outwardly similar, the two sets of laws have vastly different goals, as Mendes thoroughly documents. Antitrust law in the U.S. is relatively rigid and its goal is solely to keep the market free of private efforts to restrict competition. Competition laws in the EEC, on the other hand, are designed to promote only that degree of competition consistent with achieving other non-economic social goals.

The contrast of U.S. and EEC antitrust law provides Mendes with a comparative framework within which to analyze the misunderstanding and tension which results from conflict between different national and regional systems. Even more problematic, as Mendes views it, is the relationship between antitrust laws and trade policy, such as GATT. Although he speaks of trade policy generally, Mendes' analysis focuses on restrictive business practices such as those expressed in GATT. The practices targeted in GATT as anti-competitive represent the greatest degree of international consensus in this area. Mendes is particularly concerned with the Contracting parties' methods for circumventing their obligations as GATT signatories.

Mendes' lean text is divided into three parts. Part I, *International Trade and International Antitrust: An Overview*, provides an analysis of international regulation of trade and restrictive business practices. This is followed in Part II, *The U.S. and EEC Antitrust Systems*, by a detailed comparison of the two systems. Finally, in Part III, *Antitrust Policy—Trade Policy: The Crosscurrents*, Mendes brings all the previous threads together to study the interplay of antitrust and trade policy. Each section begins with an introduction, in which Mendes lets the reader know where he's going. The material is divided, and each section clearly identified, in a logical progression to the conclusion.

Although the prose style is somewhat convoluted and often redundant, the book is extensively documented. Mendes assumes his reader is fairly well-versed in international trade and antitrust law. The text is spare of background information and elaboration upon the main concepts. Each chapter has endnotes which provide the meat, expanding upon and elucidating the concepts more briefly addressed in the text. Most of the references are English language sources. Mendes also provides access to a broad range of French language sources, thus providing readers fluent in both languages the broadest possible range of information.

In his Foreword, noted GATT scholar John H. Jackson expresses a view shared by many, that "the lack of a set of international competition rules is the largest gap in the world trading system today, and one which will have to be addressed before too long, even though it is not being addressed in the current Uruguay round negotiation." Mendes has provided a compelling illustration of the need for harmonious rules in this area, as our world continues to increase its economic interdependence. He concludes by showing that constant contact has produced some "cross-fertilization" in the divergent U.S. and EEC systems. Mendes cautions that each system is likely to remain fundamentally distinct, but emphasizes the need for nations to consider the impact of their laws in the context of the world economy and not just their own. He thus provides a valuable first step in the process of harmonization.

Kristin K. Rasciner

TUCKER, ROBERT W. AND DAVID C. HENDRICKSON, THE IMPERIAL TEMPTATION: THE NEW WORLD ORDER AND AMERICA'S RESPONSE; Council on Foreign Relations Press (1992); $22.50; ISBN 0-87609-118-4; 240pp. (hardcover) Index.

The "imperial temptation" of which the authors speak is "the brief, massive use of military power in which the emphasis is placed on punishment and not rehabilitation." Tucker and Hendrickson, who have written two other books together as well as publishing extensively on their own, take as their thesis the bankruptcy of American ideals at the end of the Cold War. They focus on the Persian Gulf War as it exemplifies the U.S. vision of the "new world order." In the wake of the Cold War, military force occupies a disproportionate role in U.S. foreign policy. Tucker and Hendrickson maintain that the readiness with which the U.S. used military force against Iraq, despite alternatives, illustrates this disproportionality.

The book is divided into three sections, beginning with an introduction setting out the thesis. Endnotes are placed at the end of the book rather than the end of each chapter. The first part, *America's Road to the New World Order*, begins with a look at the development of the current focus on foreign policy in the Bush administration. First: the exit of Reagan, "the archetype of those who believe in the implacable hostility of the

Soviet Union towards the West," who nevertheless had the imagination and optimism to believe in change. Next: enter Bush, not only of differing temperament, but whose interest lay almost exclusively in foreign, not domestic policy. In Part Two, *The Gulf War: An Autopsy*, the book addresses, among other aspects, the cost and the justification for the Gulf War. This analysis prepares the reader for the authors' exploration of the impact of the War on the very soul of the U.S.. Part Three, *American Security and the National Purpose*, explores this impact in detail, drawing on examples from the history of the imperial powers.

Tucker and Hendrickson offer a controversial, but nevertheless compelling argument for the future of U.S. foreign policy. They warn that Bush's "new world order" is inconsistent with traditional American foreign policy principles. In fact they go so far, in the final chapter, as to quote the words written by William Seward, at the death of John Quincy Adams, during the Mexican War: "All nations must perpetually renovate their virtues and their constitutions, or perish."[2] They argue persuasively that President Bush has already succumbed to the "imperial temptation" that has seduced and corrupted other great powers in the past. Never has there been a greater need for the U.S. to "renovate" than now, say the authors. As they see it, without renovation, our present course will lead to the end of American history.

The book's publication date is June 10, 1992 — just in time to provoke renovation at the ballot box.

Kristin K. Rasciner

2. *See* ROBERT W. TUCKER, THE IMPERIAL TEMPTATION, at 198.

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Francis Brown

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"Human beings do not willingly degrade their environment." Patricia Adams introduces her book with a narrative of the ancient *muang faai*,

speeches succeeds in giving the reader a taste of selected topics encompassed in the broad term "international terrorism."

Lisa Berkowitz

LEGAL INSIGHTS TO INTERNATIONAL BUSINESS IN SPAIN; Explore Publications, Los Angeles, CA (1991); $249.00; ISBN 0-9630929-0-1; 381pp; Appendix, index.

At first glance, this paperback book looks like nothing more than a tremendous directory of Spanish law firms. But this volume provides information for everyone from job seekers to prospective clients to established businesses looking for information on law firms in Spain.

The book is broken down into several sections: Law Firms, Legal and Business Institutions, and Legal and Business Topics. By far the most important section is Law Firms. This section contains much more than basic directory information; it also contains thoughtful information about each firm, such as: what languages are spoken by the firm, what percentage of clients are foreign, and interviews with partners, or top officers in the case of institutions. Because the information was provided directly by the firms, there is more detail for some than for others. Some firms were more eloquent than others in expressing their views on given topics. The type of information provided in these interviews cannot be found anywhere else. The collection of personal views provides invaluable information for job-seekers or the cautious American export company seeking counsel.

The section on Legal and Business Institutions also focuses on the personal interview. An assortment of institutions provide detailed information about the nature of their businesses and their structure.

The final section, Legal and Business Topics, provides the reader with a comprehensive description of specific subjects, also collected through interviews. Here the questions are grouped alphabetically by topic, with several law firms responding. Again, the information is candid.

Explore Publications has taken a novel approach to providing readers with a much needed resource. The attempt to provide the reader with a comprehensive look at the Spanish legal community from a practitioner's view is successful. Well-thought out questions provide the opportunity for Spanish practitioners to express their understanding of the unique manner in which their legal community functions.

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the thousand-year old system of water management of Northern Thailand. Ancient farmers understood that mutual reliance was necessary for survival and managed to use the rivers to irrigate crops, water animals, and provide for their own needs, and yet still keep the water clean. Adams explains both how the farmers were brought into the system through "sweat equity" — by putting in twice the labor to compensate for the past efforts of others — and how the use of water was prioritized so that in dry years subsistence crops, such as rice, had precedence over cash crops, and distant or difficult to irrigate plots received water first. The system operated on the basis of co-dependence. All of this came to an abrupt halt when the World Bank and other international institutions brought "development" to the remote corners of the globe in the name of "progress."

This book is written in a style easily accessible to the lay-reader. The absence of footnotes makes for comfortable reading. The endnotes provide the academic support for this account of the Third World's environmental destruction and accompanying indebtedness — the double punch of Western "progress." The book's intended audience is varied, and can include environmental activists and pacifists, economists and lawyers, as well as students of world politics.

Patricia Adams portrays the environment's demise in the face of the West's appetite for raw materials: the harvesting of those materials without thought to the downstream effect of logging, deforestation, and damming of rivers. As an example, Adams describes the failure of the Bailvina and Tucurui dams in the Amazon region. According to Adams, this was partially due to inadequate planning for the effect of rising water on the vegetation. The failure to clear the reservoir area of vegetation caused the river to become incapable of supporting previous life forms. Ultimately, the dams were responsible for the demise of over three thousand native Waimiri-Atroari Indians. Adams also describes the effect of "progress" on less publicized ecosystems. The Singrauli agricultural community in India was contaminated by open pit coal mining and coal-fired electric generating plants. In Ethiopia, the Awash River Valley floodplains were destroyed to make way for sugarcane, cotton, and banana plantations. In Botswana, cattle ranching projects destroyed the grasslands and decimated the pastoral peoples' traditional economies.

In the sections on native governments' lack of foresight and greed, Adams documents the enrichment of the government, the capital flight, the revolving door of aid money — which in some cases never reached the Third World country where it was intended to be used — and the concept of "odious debt."

Adams cites Alexander Nahum Sack for the doctrine of odious debt:

> If a despotic power incurs a debt not for the needs or in the interest of the State but to strengthen its despotic regime, to repress the population that fights against it, etc., this debt is *odious for the population of all the State.*

> This debt is not an obligation for the nation; it is a regime's debt, a personal debt of the power that has incurred it, consequently it falls with the fall of this power.[1]

Adams then chronicals the Third World governments' defrauding of their countries and appropriating aid money for their own use. In the process she makes a very compelling argument for forgiveness of the debt.

Ms. Adams' conclusions are:

(1) The World Bank, international foreign aid agencies such as A.I.D. and CIDA, and the export development agencies such as the Export-Import Bank and the Export Development Corporation should be closed down.

(2) Privatization and respect for property rights are necessary to protect the Third World's environment.

(3) Forgiving the Third World's debt on humanitarian grounds will redound to everyone's sorrow.

(4) The Third World's debt crisis benefitted the environment.

Ruben M. Hernandez

LOWRY, HOUSTON PUTNAM, CRITICAL DOCUMENTS SOURCEBOOK ANNOTATED- INTERNATIONAL COMMERCIAL LAW AND ARBITRATION; Little Brown and Company (1991); ISBN 0-316-53404-8; 532pp. Annotations, bibliography.

Houston Putnam Lowry has assembled ten documents in use in international commercial and corporate practice, and seventeen documents in international arbitration and dispute resolution. He provides the nature and purpose of the document, the countries which have become party to it and a comparison to the U.S. equivalent. The annotations provide specific comparisons to applicable U.S. law, e.g. the Uniform Commercial Code, Statute of Frauds, and the Federal Rules of Civil Procedure. Where applicable, he provides a bibliography of any existing analysis of the document.

Rapidly expanding international market participation by American companies makes the book timely. The expansion of the market itself — the opening of the Eastern Bloc markets and expansion of the European Common Market — also mandates a reference such as this.

Both neophyte and experienced international practitioners are the target audience of the book. Lowry's own previous reliance on a "makeshift, dog-eared photocopy" of necessary international materials prompted him to prepare this sourcebook. This is the first single volume reference of this type to be printed. As the U.S. becomes increasingly more involved in international markets, the value of this resource will

1. *See* PATRICIA ADAMS, ODIOUS DEBTS, at 165.

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COBBAN, HELENA, THE SUPERPOWERS AND THE SYRIAN-ISRAELI CONFLICT; Praeger Publishers, New York, NY (1991); $19.95; ISBN 0-275-93944-8; 208pp. (hardcover).

Cobban succeeds in offering a detached, unemotional analysis of the highly complex and controversial issue of the Syrian-Israeli dispute. Her analysis begins with the central premise that the dispute is a function of local rivalry, rather than the result of inter-power conflict. Encompassing the evolution of the military balance between Israel and Syria from 1978 through 1990, the book focuses on the effects of the close strategic ties that developed between the two and their superpower partners.

This work was intended as a historical case study of developments among Israel, Syria, the Soviet Union and the United States during this limited period. The goal of this approach was to illustrate valuable lessons for application in the 1990s. After the Gulf War, the work has particular historic relevance.

The book begins with an up-to-the-minute preface analyzing the effects of the Persian Gulf War on the balance of the Syrian-Israeli relationship. Miraculously, the Gulf War aligned Syria and Israel on the "same side" of the conflict, and dramatically altered relations between the two. Cobban analyzes the impact the Gulf war had on Syria and Israel, as well as the impact on the relationship between their superpower allies. Ongoing strife in Lebanon is also addressed, since it proved to be a crucial factor in the Syrian-Israeli relationship, and in that of the powers maneuvering for influence in the Middle East.

Cobban continues her analysis by examining the region's relative immunity to various diplomatic efforts, efforts successful in other areas of the world during the 1980s. Special note is made of the fact that the arsenals of Syria and Israel, now the preeminent powers in the Middle East, remain a serious global threat.

A formula for well-considered diplomacy in the 1990s that could lead to a lasting peace concludes the book. Cobban suggests that policymakers considering the challenge of Arab-Israel peacemaking in this decade can gain useful lessons from the Syrian-Israeli conflict of the 1980s. The most important lesson, says Cobban, is that the volatile conflict between Israel and her neighbors must be moved into real negotiations that address the concerns of all those involved.

MENDES, MARIO MARQUES, ANTITRUST IN A WORLD OF INTERRELATED ECONOMIES; Editions de l'Université de Bruxelles, Belgique (1991); ISBN 2-8004-1019-1; 267pp. Foreword by John H. Jackson, bibliography.

Originally written in 1983-84 as a requirement for an LLM degree from the University of Michigan, this work was expanded and extensively

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Originally written in 1983-84 as a requirement for an LLM degree from the University of Michigan, this work was expanded and extensively

Although the prose style is somewhat convoluted and often redundant, the book is extensively documented. Mendes assumes his reader is fairly well-versed in international trade and antitrust law. The text is spare of background information and elaboration upon the main concepts. Each chapter has endnotes which provide the meat, expanding upon and elucidating the concepts more briefly addressed in the text. Most of the references are English language sources. Mendes also provides access to a broad range of French language sources, thus providing readers fluent in both languages the broadest possible range of information.

In his Foreword, noted GATT scholar John H. Jackson expresses a view shared by many, that "the lack of a set of international competition rules is the largest gap in the world trading system today, and one which will have to be addressed before too long, even though it is not being addressed in the current Uruguay round negotiation." Mendes has provided a compelling illustration of the need for harmonious rules in this area, as our world continues to increase its economic interdependence. He concludes by showing that constant contact has produced some "cross-fertilization" in the divergent U.S. and EEC systems. Mendes cautions that each system is likely to remain fundamentally distinct, but emphasizes the need for nations to consider the impact of their laws in the context of the world economy and not just their own. He thus provides a valuable first step in the process of harmonization.

Kristin K. Rasciner

TUCKER, ROBERT W. AND DAVID C. HENDRICKSON, THE IMPERIAL TEMPTATION: THE NEW WORLD ORDER AND AMERICA'S RESPONSE; Council on Foreign Relations Press (1992); $22.50; ISBN 0-87609-118-4; 240pp. (hardcover) Index.

The "imperial temptation" of which the authors speak is "the brief, massive use of military power in which the emphasis is placed on punishment and not rehabilitation." Tucker and Hendrickson, who have written two other books together as well as publishing extensively on their own, take as their thesis the bankruptcy of American ideals at the end of the Cold War. They focus on the Persian Gulf War as it exemplifies the U.S. vision of the "new world order." In the wake of the Cold War, military force occupies a disproportionate role in U.S. foreign policy. Tucker and Hendrickson maintain that the readiness with which the U.S. used military force against Iraq, despite alternatives, illustrates this disproportionality.

The book is divided into three sections, beginning with an introduction setting out the thesis. Endnotes are placed at the end of the book rather than the end of each chapter. The first part, *America's Road to the New World Order*, begins with a look at the development of the current focus on foreign policy in the Bush administration. First: the exit of Reagan, "the archetype of those who believe in the implacable hostility of the

Soviet Union towards the West," who nevertheless had the imagination and optimism to believe in change. Next: enter Bush, not only of differing temperament, but whose interest lay almost exclusively in foreign, not domestic policy. In Part Two, *The Gulf War: An Autopsy*, the book addresses, among other aspects, the cost and the justification for the Gulf War. This analysis prepares the reader for the authors' exploration of the impact of the War on the very soul of the U.S.. Part Three, *American Security and the National Purpose*, explores this impact in detail, drawing on examples from the history of the imperial powers.

Tucker and Hendrickson offer a controversial, but nevertheless compelling argument for the future of U.S. foreign policy. They warn that Bush's "new world order" is inconsistent with traditional American foreign policy principles. In fact they go so far, in the final chapter, as to quote the words written by William Seward, at the death of John Quincy Adams, during the Mexican War: "All nations must perpetually renovate their virtues and their constitutions, or perish."[2] They argue persuasively that President Bush has already succumbed to the "imperial temptation" that has seduced and corrupted other great powers in the past. Never has there been a greater need for the U.S. to "renovate" than now, say the authors. As they see it, without renovation, our present course will lead to the end of American history.

The book's publication date is June 10, 1992 — just in time to provoke renovation at the ballot box.

Kristin K. Rasciner

2. *See* ROBERT W. TUCKER, THE IMPERIAL TEMPTATION, at 198.

BOOKS RECEIVED

LODGE, TOM, ALL, HERE, AND NOW: BLACK POLITICS IN SOUTH AFRICA IN THE 1980'S; Ford Foundation — Foreign Policy Association (1992); $14.95; ISBN 0-87124-138-2; 327pp. Appendices, glossary, bibliography, index.

SCHRIRE, ROBERT, ADAPT OR DIE: THE END OF WHITE POLITICS IN SOUTH AFRICA; Ford Foundation — Foreign Policy Association (1992); $10.95; ISBN 0-87124-143-9; 143pp. Appendices, bibliography, index.

DUGARD, JOHN, ET. AL., THE LAST YEARS OF APARTHEID: CIVIL LIBERTIES IN SOUTH AFRICA; Ford Foundation — Foreign Policy Association (1992); $12.95; ISBN 0-87124-145-5; 145pp. Appendices, bibliography, index.

JASTER, ROBERT, ET. AL., CHANGING FORTUNES; WAR, DIPLOMACY, AND ECONOMICS IN SOUTHERN AFRICA; Ford Foundation — Foreign Policy Association (1992); $12.95; ISBN 0-87124-44-7; 134pp. Appendices, bibliography, index.

MUSLIH, MUHAMMAD AND AUGUSTUS RICHARD NORTON, POLITICAL TIDES IN THE ARAB WORLD; Foreign Policy Association, Ithaca, NY (1991); $4.00; ISBN 0-87124-142-0; 69pp. Reading List.

THE ARAB-ISRAELI CONFLICT, VOLUME IV: THE DIFFICULT SEARCH FOR PEACE (1975-1988) PART ONE; Edited by John Norton Moore; Princeton University Press, Princeton, NJ (1991); $99.50; ISBN 0-691-05648-X; 1066pp. Introduction, maps.

THE ARAB-ISRAELI CONFLICT, VOLUME IV: THE DIFFICULT SEARCH FOR PEACE (1975-1988) PART TWO; Edited by John Norton Moore; Princeton University Press, Princeton, NJ (1991); $99.50; ISBN 0-691-05678-1; 1925pp. Permissions, bibliography.

LIBER AKKERMAN: IN- AND OUTLAWS IN WAR; Edited by P.J. van Krieken & Ch. O. Pannenborg; MAKLU Publishers, Antwerpen, Belgium (1992); ISBN 90-6215-322-4; 307pp. Biography, list publications, contributors, acknowledgments.